81-2367

No. ___

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

SOLITRON DEVICES, INC., BENJAMIN FRIEDMAN, JAMES S. TRAGER and JAMES P. BARRY,

Petitioners,

—against—

HOWARD SIROTA and FAMILY RESTORATIONS, a Partnership, on behalf of themselves and all others similarly situated,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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QUESTIONS PRESENTED FOR REVIEW

I. In a determination before trial of the qualifications under Rule 23(a) of plaintiffs as class representatives, is the District Court precluded by *Eisen v. Carlisle and Jacquelin*, 417 U.S. 156 (1974), from conducting an inquiry into the facts of the typicality of plaintiffs' individual claims?

II. When after trial it becomes manifest that the claim of the individual plaintiffs were never typical of the class, is the District Court precluded from decertifying by *East Texas Freight Systems, Inc. v. Rodriguez*, 431 U.S. 395 (1977)?

III. In a fraud-on-the-market case under section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, can damages be based on "expert" testimony concerning hypothetical stock values when objective market facts are readily available and directly contradictory?

PARTIES

Petitioners are defendants Solitron Devices, Inc. ("Solitron"), Benjamin Friedman, James S. Trager and James P. Barry.*

Respondents are plaintiffs Howard Sirota and Family Restorations, a Partnership, on behalf of themselves and a class of which they concededly are not and never have been members.

The claims of the class which Robert J. Berk and Bruce M. Umlas represent were dismissed by the District Court and that dismissal was affirmed by the Court of Appeals.

Union Carbide Corporation intervened after trial, but withdrew from the action prior to the appeal to the Court of Appeals.

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* Defendant Louis Sternbach & Co. has informed us that it intends to submit a petition for a writ of certiorari on partially separate issues.

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SOLITRON DEVICES, INC., BENJAMIN FRIEDMAN, JAMES S. TRAGER and JAMES P. BARRY,

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—against—

HOWARD SIROTA and FAMILY RESTORATIONS, a Partnership, on behalf of themselves and all others similarly situated,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioners Solitron Devices, Inc., Benjamin Friedman, James S. Trager and James P. Barry respectfully petition this Court for a writ of certiorari to review the opinion and judgment of the United States Court of Appeals for the Second Circuit issued in this action on February 19, 1982, as amended on May 13, 1982.

OPINIONS BELOW

The opinion of the Court of Appeals (5a-24a) is reported at 673 F.2d 566 (2d Cir. 1982). The opinion of the District Court (31a-67a) is not reported. The class certification decisions of the District Court (68a-82a) are also not reported.*

JURISDICTION

The decision of the Court of Appeals for the Second Circuit was filed on February 19, 1982. The Court of Appeals amended its opinion but denied a petition for rehearing on May 13, 1982. It granted a stay of its mandate for thirty days on May 26, 1982. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

RELEVANT STATUTES AND RULES

1. Rule 23 of the Federal Rules of Civil Procedure, Fed. R. Civ. P. 23:

RULE 23. *Class Actions*

(a) *Prerequisites to a Class Action.* One or more members of a class may sue or be sued as representative parties on behalf of all only if (1) the class is so numerous that joinder of all members is impracticable, (2) there are questions of law or fact common to the class, (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class, and (4) the representative parties will fairly and adequately protect the interests of the class.

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* The judgment of the District Court (27a-61a), the judgment of the Court of Appeals (25a-26a) and the order of the Court of Appeals on the petition for rehearing (1a-4a) are also reproduced in the Appendix.

(c) Determination by Order Whether Class Action to be Maintained; Notice; Judgment; Actions Conducted Partially as Class Actions.

(1) As soon as practicable after the commencement of an action brought as a class action, the court shall determine by order whether it is to be so maintained. An order under this subdivision may be conditional, and may be altered or amended before the decision on the merits.

• • •

2. Section 10(b) of The Securities Exchange Act of 1934, as amended, 15 U.S.C. § 78j(b) (the "1934 Act"):

§ 78j. Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

• • •

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

3. Rule 10b-5, 17 C.F.R. § 240.10b-5:

§ 240.10b-5 *Employment of manipulative and deceptive devices.*

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

STATEMENT OF THE CASE

A. Factual Background

This is a class action in which Solitron Devices, Inc., ("Solitron"), a manufacturer of electronic semi-conductors, Benjamin Friedman, its president, James S. Trager, a part-time clerk employed by Solitron's former independent auditors in 1967 and 1968 who, in 1969, became comptroller of Solitron's Tappan, New York office, and James P. Barry, a staff accountant employed by Solitron (the "Solitron Defendants"), were found liable by a jury under Section 10(b) of the 1934 Act and Rule 10b-5 promulgated thereunder for overstating Solitron's income for the years 1967, 1968, and part of 1970.

The case arose in the following manner: In 1974, Solitron was seeking to establish before The Renegotiation Board its financial results for 1967-70, a period during which its independent auditor was Louis Sternbach & Co. ("Sternbach"). It instructed Price Waterhouse & Co. ("Price Waterhouse"), its then auditor, to review its accounting methods for those years. In late 1974, Price Waterhouse completed its study, and advised Solitron that its financial statements for 1966-70 were in error with respect to, among other things, the inventory valuation at its Florida plant as approved by Sternbach. These errors had the effect of overstating Solitron's profitability for 1967, 1968 and 1970 and understating it for 1969.

The Renegotiation Board rejected Price Waterhouse's conclusions but delivered its reports to the Securities and Exchange Commission which thereupon initiated an injunctive proceeding against Solitron in the District of Columbia. Within hours of the filing of this complaint, plaintiffs Sirota and Family Restorations filed fraud complaints against the Solitron Defendants and Solitron's auditors on their own behalf and on behalf of purchasers of Solitron shares in the market as inflated by the erroneous financial statements. One month later, the SEC dropped its charges against Solitron. This class action nevertheless proceeded.

B. The Class Certification Decision.

At the earliest stages of this lawsuit and repeatedly thereafter, defendants strenuously argued that neither Family Restorations nor Howard Sirota were proper class representatives, because they themselves could not assert claims "typical of the claims or defenses of the class" as Rule 23(a)(3) requires.

The asserted basis for defendants' argument was simple and indisputable: The plaintiffs alleged Solitron's financial statements from 1967 to 1971 falsely "emphasized the tremendous and continuous growth at Solitron." On December 14, 1970, however, Solitron had released a public statement (the "Press Release"), carried on the Dow Jones "Broad Tape" and in the financial press, reporting for the nine-month period ended November 30, 1970, a pre-tax loss of $7,000,000 based upon an inventory writedown reflecting a drastic recession in the electronics industry. The effect of this writedown was to terminate forcefully the record of growing profitability which had characterized Solitron's operations since its organization.

It was four months after the Press Release, on April 7, 1971, that plaintiff Family Restorations made its first and only purchase of shares (400) of Solitron. It was seven months after the Press Release, on June 1, 1971, that plaintiff Howard Sirota purchased his only shares (25) of Solitron. Solitron's position in the District Court was that the public announcement of a $7,000,000 nine-month loss utterly and dramatically

purged the market of any impact of inflated earnings as charged in plaintiffs' complaint on behalf of the class. Because both plaintiffs bought their only Solitron shares long after the Press Release, neither of them could assert claims on their own behalf typical of the claims of persons who purchased Solitron stock before the Press Release.

Plaintiffs attempted to confuse this issue by claiming that the Press Release itself was fraudulent because it failed to disclose Solitron's motive for the writedown. In response, defendants repeatedly pointed out that even if the Press Release were fraudulent (which, as established at trial, it was not) the conclusion would have been the same. The class bought Solitron stock before the Press Release and based its claims on inaccuracies in Solitron's prior annual financial statements reflecting "tremendous and continuous growth," causing, in turn, inflated prices paid for the stock. Family Restorations and Sirota bought their only Solitron shares long after the Press Release. On the face of it, the two claims are utterly different and completely unrelated. Thus, Family Restorations and Sirota were not members of the class and did not have claims typical of those of the class. They were strangers to the class. Under Rule 23(a)(3) they could not qualify as class representatives.

The District Court rejected the arguments presented by the Solitron Defendants. The District Court held that *Eisen v. Carlisle and Jacquelin*, 417 U.S. 156 (1974), prohibited it from reviewing any facts concerning whether plaintiffs had claims typical of the persons who purchased Solitron stock prior to the Press Release because those facts also related to the merits of the case, *i.e.*, whether either Sirota or Family Restorations individually had a valid cause of action. The Court then certified the class on the basis of the pleadings alone, again erroneously citing the *Eisen* decision:

> From the limited vantage point permitted under the *Eisen* doctrine, the series of statements and reports relied

> upon by plaintiffs *in their pleadings* provide the essential continuity of omissions and misrepresentations necessary to bring the period from May 5, 1967 to March 20, 1975 within the scope of the common questions requirement. (Emphasis added) (71a-72a; see 75a-76a; 53a)

Having successfully gotten past the certification issue, at trial the plaintiffs abandoned the claim that the Press Release was fraudulent, they did not even attempt to present evidence showing inaccuracies in the Press Release and readily stipulated that the Press Release did indeed close the class. In short, plaintiffs were not members of the class and never had been members of the class. Indeed, by a continuing misrepresentation of typicality to the District Court, plaintiffs usurped the class claims based on the charged overstatement of earnings.

At the close of plaintiffs' case, and again after trial but before submission to the jury, defendants moved to decertify the class and to dismiss. Notwithstanding that it had been crudely misled by the plaintiffs from the outset of the case, the District Court persisted in its erroneous reading of *Eisen* and denied defendants' motions, stating however:

> . . . I am willing to say that if hindsight were foresight, [Family Restorations and Sirota] shouldn't have been designated as class representatives because of the dates. (13a, n. 1)

C. The Opinion Of The Court Of Appeals

The Court of Appeals based its affirmance of the judgment below on after-the-fact conjecture not supported by the record:

> Here too the district court *may properly have believed* at the time of the decision to certify that there was a substantial question of fact for the jury whether the December 1970 press release had cured the market, barring post-December claims, or was itself, fraudulent. (Emphasis supplied) (13a)

The District Court made it clear on the record that it did not base its decision on any such grounds. Instead, it held that *Eisen* barred it from making the simplest factual inquiry. Furthermore, the Court of Appeals ignored defendants' argument that even if the named plaintiffs had claims, manifestly they were completely unrelated to the claims asserted by them on behalf of the class.

Finally, the Court of Appeals held, with regard to defendants' motion for decertification, when the true facts became so manifest that plaintiffs themselves were obliged to stipulate to them and the District Court responded that it would not have certified had it known the facts, that the District Court "need not decertify whenever it later appears that the named plaintiffs were not class members . . ." It cited for authority a case not on point but one in which the plaintiff's status had been changed *subsequent* to the initiation of the action so as to eliminate his individual cause of action, *East Texas Motor Freight Systems, Inc. v. Rodriguez*, 431 U.S. 395 (1977). In the instant case, however, the plaintiffs very simply never were members of the class; they bore absolutely no relationship to the class. It utterly nullifies Rule 23 to say that its requirements respecting the qualifications of class representatives can be met at the time of certification by reliance on vague factual assertions in a complaint or by plaintiffs' counsel's oral representations, and that when the truth becomes known before final judgment, it is too late to cure the situation. Such reasoning never allows defendants a "day in court" on this issue.

Permitting strangers to a class to represent that class in a litigation because a jury verdict supposedly "favorable" to the class was returned, as the Court of Appeals did (14a), is contrary to basic precepts of our procedural jurisprudence. Aside from the point that it leaves open the question of who is to deem an outcome "favorable" to a class, the question remains—suppose the outcome had not been favorable: would the class be bound by a litigation conducted on its behalf by utter strangers? *See Scott v. University of Delaware*, 601 F.2d 76 (3d Cir.), *cert. denied*, 444 U.S. 931 (1979).

The Court of Appeals affirmed the finding of liability citing as motivation for the "fraud" of defendants "numerous" (15a) instances of acquisitions by Solitron during the years in issue with its allegedly over-valued stock. It reversed and remanded the damage award for 1970 on the grounds that it was inconsistent with objective market facts concerning the price of Solitron stock. It failed to apply the same principle to the damage awards for 1967 and 1968 although based upon the same theory as applied to 1970.

D. The Petition For Rehearing

The Solitron Defendants petitioned the Court of Appeals for rehearing. They argued among other things that virtually all of the cited acquisitions for stock upon which the Court of Appeals had relied to support the finding of a fraudulent motive were in fact made solely for cash. The only issuances by Solitron of its stock during the 1967-70 period were:

a. In 1967, Solitron issued shares of its stock in a tender offer of shares for Amphenol Corporation. This was litigated by Amphenol in the U.S. District Court for the Northern District of Illinois. The Court found that Solitron's books and records were accurate in all respects and that the market accurately reflected the value of its shares. (*Amphenol Corp. v. Solitron Devices, Inc.*, 68 Civ. 161 (N.D. Ill.))

b. In 1968, Solitron acquired Filmholm Corporation with $329,000 in cash and 63,100 shares of treasury stock. All of the cash went to the non-affiliated investors in Filmholm, whereas all of the stock went to those Filmholm investors who were close relatives and business associates of Solitron's treasurer, *i.e.*, all Solitron "insiders."

c. In January 1969, Solitron acquired Microwave Chemicals Laboratory, Inc. for $91,000 in cash plus a *de minimis* amount (500 shares) of treasury stock.

On May 13, 1982, the Court of Appeals denied the Solitron Defendants' petition for rehearing, but amended its opinion to

exclude reference to those "numerous" acquisitions which had, in fact, been made entirely for cash. However, the Court of Appeals' opinion is still misleading, inasmuch as it precedes the few instances of stock acquisitions with the words "[f]or example," (2a) suggesting that there were additional acquisitions for stock when in fact there were not. Furthermore, the Court's opinion fails to mention the undisputed fact that during the time that Solitron's stock was allegedly overpriced, the individual defendants were buying, and none had sold, Solitron stock. The opinion also fails to mention the mitigating circumstances concerning the three stock acquisitions which have already been discussed. Finally, the Court failed to apply the same principle it had applied to the damage findings for 1970 to the damage findings for 1967 and 1968; instead, it ignored the behavior of the stock market in 1967-8 and affirmed the damage awards for those years.

REASONS FOR GRANTING THE WRIT

I. AN IMPORTANT ISSUE OF FEDERAL LAW HAS BEEN RAISED IN THIS CASE RESPECTING THE QUALIFICATION OF CLASS REPRESENTATIVES PURSUANT TO RULE 23(a) IN A CLASS CERTIFICATION DETERMINATION PRIOR TO TRIAL. A SPLIT OF AUTHORITY EXISTS AMONG THE COURTS OF APPEALS RESPECTING THIS ISSUE AND THE PROPER IMPACT THEREON OF THIS COURT'S DECISION IN *EISEN v. CARLISLE AND JACQUELIN*, 417 U.S. 156 (1974)

At the earliest stages of this lawsuit and repeatedly thereafter, defendants strongly argued that plaintiffs were not proper class representatives because their individual claims were not "typical of the claims or defenses of the class" as Rule 23(a)(3) requires ("only if").

Defendants' position on the issue of typicality is reflected in *In Re LTV Securities Litigation*, 88 F.R.D. 134 (N.D. Tex. 1980). In fact, the position of the Solitron Defendants is far

stronger. In *LTV*, also a 10b-5 action, as here, plaintiffs sought certification for a class of persons who had purchased LTV stock at a time when LTV's published inventory figures allegedly were overstated. LTV opposed the class termination date proposed by plaintiffs on the ground that the class period was closed by its press release of July 17, 1978, which stated that future inventory adjustments would have a material affect on its prior reported earnings. Plaintiffs argued that until the exact amount of the inventory's impact on earnings was determined, the class should remain open. The District Court in *LTV* held a precertification hearing, examined the evidence and then rejected the plaintiffs' argument as follows:

> By this plaintiffs are at least implicitly arguing that market reliance ought to be presumed despite the announcement to the market. Plaintiffs' heavy dependence upon the "fraud on the market" theory cuts against them. It is the sensitivity of the open market and its ability to sort the data bits into mosaics of value that underpins any validity of the fraud on the market theory. No one contends this market turned stoned deaf on July 17, 1978. It follows that with the announcement made and the trading having been suspended for 10 days, those persons who purchased thereafter are not members of the same class as those who purchased earlier. The postannouncement purchasers are confronted with factual defenses unique to them. (*Id.* at 148.)

Accord, Piel v. National SemiConductor Corp., 86 F.R.D. 357, 369, n.12, n.13 (E.D. Pa. 1980).

Here, the District Court refused to inquire into defendants' claim that plaintiffs were not proper representatives of the class. The District Court based its refusal on the grounds that the effects of the Press Release touched on the merits of plaintiffs' claims and that this Court's decision in *Eisen v. Carlisle and Jacquelin*, 417 U.S. 156 (1974), precluded it from considering any matter relating to the merits of the case in making a determination of typicality under Rule 23(a)(3).

Consequently, the District Court considered only the pleadings and found that plaintiffs had alleged a total class which would encompass them. Defendants' position on the issue of typicality was vindicated when, at trial, the plaintiffs made no effort to show that the Press Release was fraudulent, abandoned their individual claims, and stipulated that the Press Release indeed closed the class. The District Court could only express its frustration when, at the close of trial, it stated in response:

> . . . I am willing to say that if hindsight were foresight, [Family Restorations and Howard Sirota] shouldn't have been designated as class representatives because of the dates. (13a, n.1)

Then, citing *Eisen*, the District Court sent the case to the jury. The opinion of the Court of Appeals did not cure this error, but merely confused the issue by going off on conjecture as to what the District Court "may properly have believed" before trial in certifying the class.

1. Important Issue of Federal Law

The question of factual determination prior to trial is really one of appropriateness. In *Eisen* this Court properly ruled that it was not appropriate to impose the financial burden of a class action on defendants until there had been a determination after trial of liability. On the other hand, the question of qualification of class representatives of its very nature is a threshold issue on which some pretrial determination based upon factual showing should be made lest the trial court, as was the case here, be confronted with the dilemma of going through a lengthy trial only to find that the class representatives do not qualify under Rule 23(a). The District Court did not make this distinction and took *Eisen* to preclude it from any such pretrial factual inquiry. The reliance of the Court of Appeals on what the District Court "may properly have believed," at best confuses what was obviously an erroneous position of the District Court. In order to avoid in the future the dilemma of the District Court, when faced after a lengthy trial with the reality that the plaintiffs had misrepresented themselves, this Court should clarify the matter.

The District Court's extention of *Eisen* to cover the basic qualifications of would-be class representations raises an important question of federal law. As it stands, boot-strapping plaintiffs can qualify merely on the basis of generalized allegations in their complaints. The question thus raised goes to the very viability of the criteria of Rule 23(a) of the Federal Rules of Civil Procedure.

In *Eisen*, the District Court held a preliminary hearing and, after finding that plaintiffs were likely to prevail on the merits, required defendants to bear the cost of notice to members of the proposed class. This Court held that Rule 23 does not authorize a District Court to hold a pre-trial hearing on the merits in order to determine whether it may be maintained as a class action for purposes of assessing certain costs:

> We find nothing in either the language or history of Rule 23 that gives a Court any authority to conduct preliminary inquiry into the merits of a suit in order to determine whether it may be maintained as a class action. Indeed, such a procedure contravenes the Rule by allowing a representative plaintiff to secure the benefits of a class action without first satisfying the requirements for it. (*Id.* at 177).

In *Eisen* this Court did *not* prohibit a District Court from conducting any precertification inquiry that happens to touch on matters that may also relate to the merits of the case. *Stastny v. Southern Bell Telephone & Telegraph Co.*, 628 F.2d 267, 275 n. 10 (4th Cir. 1980); *Cobb v. Avon Products, Inc.*, 71 F.R.D. 652 (W.D. Pa. 1976), *app. dismissed*, 565 F.2d 151 (1977); *Professional Adjusting Systems of America v. General Adjustment Bureau*, 64 F.R.D. 35 (S.D.N.Y. 1974) ("It should take more than "*ipse dixit*" to make a class.") On the contrary, this Court heid only that in considering whether a suit may be maintained as a class action, the question is whether the requirements of Rule 23 have been met and not whether the plaintiff is likely to prevail on the merits.

This distinction was recognized in *Huff v. N.D. Cass Company of Alabama*, 485 F.2d 710 (5th Cir. 1973):

"On the merits" is an elusive term at best, not wholly suitable as a guideline in this situation. In a sense, much that plaintiff alleges with respect to his individual claim goes to the "merits" of his claim. A plaintiff who seeks to represent all employees on a claim of discriminatory denial of promotions might, if the case goes to trial, lose on his individual claim because it turns out that he was never employed by the defendant. Retrospectively, one might say he lost "on the merits." Yet there is no doubt that the court could lay bare at a preliminary stage this fact concerning the plaintiff, and, having done so, conclude plaintiff was not a proper representative because he lacked the nexus with the class and its interests and claims which is embraced in the various requirements of 23(a) and (b). It is inescapable that in some cases there will be overlap between the demands of 23(a) and (b) and the question of whether plaintiff can succeed on the merits. (*Id.* at 714).

2. Conflict Among The Circuits.

A number of federal Courts of Appeals have held that in determining whether an action is maintainable as a class action under Rule 23, a District Court should hold a hearing and consider evidentiary matters, even if those matters relate to the merits of the action. *Yaffy v. Powers*, 454 F.2d 1362 (1st Cir. 1972); *Doctor v. Seaboard Coast Line R. Co.*, 540 F.2d 699 (4th Cir. 1976); *Cruise v. Estelle*, 497 F.2d 496 (5th Cir. 1974); *Huff v. N.D. Cass Company*, 485 F.2d 710 (5th Cir. 1973) (en banc); *Miller v. Mackey International Inc.*, 452 F.2d 424 (5th Cir. 1971); *Weathers v. Peters Realty Corporation*, 499 F.2d 1197 (6th Cir. 1974); *Rossin v. Southern Union Gas Company*, 472 F.2d 707 (10th Cir. 1973). Moreover, the Court of Appeals for the Fourth Circuit has expressly held that *Eisen* does not preclude a precertification inquiry designed to establish class action criteria that happens to touch on the merits of the class or individual claims. *Stastny v. Southern Bell Telephone & Telegraph Co* 628 F.2d 267, 275 n.10 (4th Cir. 1980). And, a

district court in the Third Circuit has recognized that *Eisen* does not preclude consideration of the merits in determining whether the requirements of Rule 23 have been satisfied. *Cobb v. Avon Products, Inc.*, 71 F.R.D. 652 (W.D. Pa. 1976). These decisions in other circuits conflict with the decision of the Court of Appeals in this case. In order to resolve this conflict, this Court should issue a writ of certiorari to the United States Court of Appeals for the Second Circuit.

II. THE DECISION OF THE COURT OF APPEALS RESPECTING DEFENDANTS' MOTION FOR DECERTIFICATION FOLLOWING TRIAL BUT PRIOR TO PRESENTING THE CASE TO THE JURY, COMBINED AS IT IS WITH ITS AFFIRMANCE OF THE ORIGINAL CERTIFICATION, NULLIFIES THE EFFECTIVENESS OF RULE 23(C). THE DECISION, THEREFORE, PRESENTS AN IMPORTANT QUESTION OF FEDERAL LAW AND IS CONTRARY TO THE AUTHORITY IN OTHER FEDERAL CIRCUITS

After trial but before submission to the jury, the District Court admitted that its certification of Sirota and Family Restorations as class representatives was improper. Nevertheless, the District Court denied the defendants' motion to decertify the class. The Court of Appeals affirmed holding that under the decision of this Court in *East Texas Motor Freight System, Inc. v. Rodriguez*, 431 U.S. 395 (1977), the District Court properly declined to decertify. The decision of the Court of Appeals on this point raises an important issue of federal law which conflicts with decisions in other circuits.

1. Important Issue of Federal Law.

Rule 23(c)(1) expressly provides that an order determining whether an action may be maintained as a class action "may be altered or amended before the decision on the merits." The 1966 advisory committee notes to this sub-section leave no doubt that:

> A determination once made can be altered or amended before the decision on the merits if, upon further development of the facts, the original determination appears unsound.

Notes of Advisory Committee on Rules, 28 U.S.C.A., Rule 17-23, at page 300 (1982).

The decision of this Court in *East Texas Motor Freight, Inc. v. Rodriguez*, 431 U.S. 395, *supra*, does not preclude decertification when the facts at trial conclusively demonstrate that the initial decision to certify was improper. In *Rodriguez*, the question before this Court was whether plaintiffs were appropriate representatives of a class consisting of all Mexican-American and black applicants for line-driver positions who allegedly had been discriminated against by defendant. Prior to trial, plaintiffs did not move for certification of the class. The evidence at trial demonstrated that plaintiffs were not proper class representatives and the District Court refused certification. On appeal, the Fifth Circuit reversed and certified the class. This Court reversed the decision of the Fifth Circuit, holding that "the trial court proceedings [had] made clear that [plaintiffs] were not members of the class they sought to represent." 431 U.S. at 403.

In *dictum*, this Court noted that it was not faced with a case in which the District Court had properly certified a class prior to trial:

> Obviously, a different case would be presented if the District Court had certified a class and only later had it appeared that the named plaintiffs were not class members or were otherwise inappropriate class representatives. In such a case, the class claims would have already been tried, and, *provided the initial certification was proper and decertification not appropriate*, the claims of the class members would not need to be mooted or destroyed because subsequent events or the proof at trial had undermined the named plaintiffs' individual claims. (Emphasis added) (431 U.S. at 406 n. 12)

Rodriguez does not support the conclusion of the Court of Appeals for a number of reasons. First, it is basic that *Rodriguez* was a racial discrimination case, plaintiff was a member of the victim element and clearly had an ultimate stake in the outcome which was directed at an overall remedial pronouncement, even if his own particular claim was undermined by subsequent events. Moreover, in the *dictum* of *Rodriguez*, this Court stated only that "the claims of the class members would not need to be mooted or destroyed" if "the initial certification was proper and *decertification not appropriate*." In this case, defendants' position below was that the initial certification was not proper and that decertification was appropriate. Thus, *Rodriguez* has absolutely no bearing on the issue before this Court. Finally, it is essential to remember that the holding in *Rodriguez* was that a plaintiff may not represent a class when the facts at trial demonstrate that he is not a member of the class. Simply stated, *Rodriguez* supports defendants' position that the District Court should have decertified the class when the facts at trial conclusively demonstrated that plaintiffs were never related to the class.

The practical effect of the decision of the Court of Appeals is that a defendant is denied any opportunity to challenge a class certification on the facts rather than the unsupported allegations of the complaint. Prior to certification, *Eisen* prevents the District Court from considering any facts relating to Rule 23 criteria that also touch on the merits of the case or, on review, the Court of Appeals may rely on a speculation as to what the District Court "might" have believed. In practical effect, the District Court is bound by the self-serving allegations of the complaint. After trial, *Rodriguez* precludes decertification provided that the plaintiffs prevail on the merits and the original certification was "proper" in the narrow sense that it was supported by the allegations of the complaint. The result is absurd. Any plaintiff can bootstrap his way into control of a class claim simply by pleading facts sufficient to satisfy the requirement of Rule 23. And, the decision of the Court of Appeals insulates such an unscrupulous plaintiff from decertification when the facts at trial establish that he was not and

never had been an appropriate class representative. In order to avoid this procedural nullification of Rule 23(a), this Court should issue a writ of certiorari to clarify the matter.

2. Conflict Among The Circuits

The decision of the Second Circuit conflicts with decisions in the Third and Fourth Circuits which have held that a District Court must decertify a class when the facts at trial demonstrate that plaintiffs are not proper class representatives. *Stastny v. Southern Bell Telephone & Telegraph Co.*, 628 F.2d 267 (4th Cir. 1980); *Scott v. University of Delaware*, 601 F.2d 76, 87 n. 22 (3d Cir.), *cert. denied*, 444 U.S. 931 (1979). Also, the decision of the Second Circuit conflicts with the decision of a District Court in the Fifth Circuit. *McLendon v. M. David Lowe Personal Service, Inc.*, 83 F.R.D. 204 (S.D. Tex. 1979). This Court should issue a writ of certiorari to the Second Circuit in order to resolve this conflict.

III. THE QUESTION OF HOW DAMAGES SHOULD BE COMPUTED IN A RULE 10b-5 CASE IS AN IMPORTANT FEDERAL QUESTION UPON WHICH THERE EXISTS A GREAT DEAL OF DISAGREEMENT AND UPON WHICH THIS COURT SHOULD PROVIDE GUIDANCE

The damage award in this case is based solely on hypothetical testimony which is contradicted by actual stock market behavior. Although the Court of Appeals reversed the damage award for 1970 because it was irrational in light of the market price of Solitron stock, the Court refused to examine the 1967 or 1968 damage awards in light of undisputed market facts. The Court of Appeals' inconsistency has repercussions beyond this case because the theoretical basis of the error lies in the "date of transaction" measure of damages. This measure of damages should not be permitted in a fraud-on-the-market case.

The proper measure of damages in Rule 10b-5 cases has escaped close scrutiny by the courts. As a result, damage

awards are often inconsistent and unjust. Jacobs, *The Measure of Damages in Rule 10b-5 Cases*, 65 Geo. L.J. 1093, 1095 (1977). Some courts measure the plaintiff's loss by the difference between the actual market value of the stock he purchased and the purchase price that he paid as of the "date of the transaction." *Harris v. American Investment Company*, 523 F.2d 220, 225 (8th Cir. 1975), *cert. denied*, 423 U.S. 1054 (1976). Many other courts, however, regard this "date of transaction" measure as too speculative and they measure damages by reference to the date on which the fraud is discovered. *Esplin v. Hirschi*, 402 F.2d 94, 104 (10th Cir. 1968), *cert. denied*, 394 U.S. 928 (1969). In cases applying this "date of discovery" method, plaintiffs' losses are measured by comparing the market price of the stock just before the publication of fraudulent information to the price of the stock just after the fraud is disclosed. The actual change in stock price serves as an objective measure of the plaintiff's damages.

In fraud-on-the-market cases, the "date of discovery" method is the only appropriate measure of damages. The fraud-on-the-market theory is based on the principle that the market reacts to published information. It is that principle which justifies the theory's presumption of reliance. The "date of discovery" method of measuring damages is consistent with the fraud-on-the-market theory in that it measures damages by reference to the market's actual reaction to information.

By contrast, attempts to measure the value of stock as of the "date of transaction," as in this case, are necessarily divorced from actual market behavior, and necessarily require the use of hypothetical "expert" testimony. This testimony, essentially based upon speculation, is an invitation to inconsistent, irresponsible and unjust damage awards. It should never be permitted in fraud-on-the-market cases when objective market data is available.

The case at bar presents a dramatic example of the injustice which the "date of transaction" method of damages can create when applied to a fraud-on-the-market case. In this action, plaintiffs alleged that Solitron's 1967 annual report overstated

Solitron's income by 10%. Their expert testified that this resulted in a constant 44% inflation of Solitron's stock price for all of 1967. It is undisputed, however, that for one and one-half months immediately following the publication of Solitron's 1967 annual report, Solitron's stock price *fell*. Plaintiffs' expert testified that Solitron's 1968 annual report caused Solitron's stock to be inflated 72.1% and that the publication of Solitron's 1969 annual report caused Solitron's stock to be deflated by 72.1%.

It is undisputed that the price of Solitron stock hardly reacted to the publication of the annual reports in question and indeed rose following the publication of the admittedly curative press release in 1970 reflecting a $7,000,000 loss. Yet, the jury, faced with the dazzling conceptualizations of plaintiffs' expert, simply applied an across-the-board factor of 75% to his estimates and, accordingly, judgment was entered.

Although it reversed the damage award for 1970 on the ground that it was far in excess of what the market data justified, the Court of Appeals refused to change the even more exaggerated damages findings for 1967 and 1968. It addressed the anomalies of the damage award as follows:

> [W]hile it seems odd that the calculations are for full years and vary sharply from the last day of one to the first day of the next, these are only hypothetical constructs which had to be made rather arbitrarily since there were no disclosures until December 1970.[*] Each year was an era and the point in time between years an epoch. (23a)

The Court's failure to adopt a consistent and rational approach to the appropriate measure of damages in a fraud-on-the-market case compounds the confusion and uncertainty surrounding this important issue in the decisions of the lower federal courts. Accordingly, this Court should issue a writ of

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* There were disclosures—the annual reports which allegedly caused and in 1969 corrected the inflation in Solitron's stock price.

certiorari to the Court of Appeals for the Second Circuit in order to provide guidance on this and future damage awards in similar cases under Rule 10b5.

CONCLUSION

For the foregoing reasons, a writ of certiorari should be granted.

Dated: June 25, 1982

Respectfully submitted,

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APPENDIX

Order of the Second Circuit on Petition for Rehearing

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

81-7357, 81-7367, 81-7377

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court House, in the City of New York, on the thirteenth day of May, one thousand nine hundred and eighty-two.

HOWARD SIROTA, FAMILY RESTORATIONS, A Partnership, ROBERT J. BERK, and BRUCE M. UMLAS, on behalf of themselves and all others similarly situated,
Plaintiffs-Appellees-Appellants,

and

UNION CARBIDE,
Plaintiff-Intervenor-Appellee-Appellant,

v.

SOLITRON DEVICES, INC., BENJAMIN FRIEDMAN, JAMES S. TRAGER, JAMES P. BARRY, and LOUIS STERNBACH & CO.,
Defendants-Appellants-Appellees.

ORDER ON PETITION FOR REHEARING

On petition for rehearing it is hereby ordered that the opinion be amended as follows:

1. Slip op. at 1369, lines 24-25, should read: "make several acquisitions.[2] There was direct evidence . . . ."

2. Slip op. at 1369 n.2 should read: "[2] For example, Solitron exchanged approximately 160,000 shares for approximately 800,000 shares of Amphenol Corporation between January and March 1968; acquired Filmohm Corporation in April 1968 for $3.24 million in cash plus 63,100 shares of treasury stock; and acquired Microwave Chemicals Laboratory, Inc., in January 1969 for $91,000 in cash plus 500 shares of treasury stock."

J. EDWARD LUMBARD
J. Edward Lumbard

JAMES L. OAKES
James L. Oakes

AMALYA A. KEARSE
Amalya A. Kearse

Circuit Judges.

At a stated term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse, in the City of New York, on the thirteenth day of May, one thousand nine hundred and eighty-two.

Nos. 81-7357, 81-7367, 81-7377

HOWARD SIROTA, FAMILY RESTORATIONS, A Partnership, ROBERT J. BERK and BRUCE M. UMLAS, on behalf of themselves and all others similarly situated,

Plaintiffs-Appellees-Cross-Appellants,

and

UNION CARBIDE CORPORATION,

Plaintiff-Intervenor-Appellant,

—against—

SOLITRON DEVICES, INC., BENJAMIN FRIEDMAN, JAMES S. TRAGER, JAMES P. BARRY,

Defendants-Appellants-Cross-Appellees,

and

LOUIS STERNBACH & CO.,

Defendant-Cross-Appellee.

Petitions for rehearing containing suggestions that the action be reheard in banc having been filed herein by counsel for the defendant-cross-appellee, Louis Sternbach & Co., and by counsel for the defendants-appellants-cross-appellees, Solitron Devices, Inc., Benjamin Friedman, James S. Trager and James P. Barry, and the panel that heard the appeal having ordered that the opinion filed February 19, 1982, be amended,

Upon consideration by the panel that heard the appeal, it is ORDERED that the said petitions for rehearing are DENIED.

It is further noted that the suggestions for rehearing in banc have been transmitted to the judges of the court in regular active service and to any other judge on the panel that heard the appeal and that no such judge has requested that a vote be taken thereon.

A. DANIEL FUSARO
A. Daniel Fusaro
Clerk

by s/ FRANCIS X. GINDHART
Chief Deputy Clerk

Opinion of the United States Court of Appeals for the Second Circuit

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Nos. 158, 310, 476—August Term, 1981

(Argued: November 9, 1981 Decided: February 19, 1982)

Docket Nos. 81-7357, 81-7367, 81-7377

HOWARD SIROTA, FAMILY RESTORATIONS, A Partnership, ROBERT J. BERK and BRUCE M. UMLAS, on behalf of themselves and all others similarly situated,

Plaintiffs-Appellees-Cross-Appellants,

and

UNION CARBIDE CORPORATION,

Plaintiff-Intervenor-Appellant,

—against—

SOLITRON DEVICES, INC., BENJAMIN FRIEDMAN, JAMES S. TRAGER, JAMES P. BARRY,

Defendants-Appellants-Cross-Appellees,

and

LOUIS STERNBACH & CO.,

Defendant-Cross-Appellee.

Before:

LUMBARD, OAKES and KEARSE, *Circuit Judges.*

Appeal from that part of an order of the United States District Court for the Southern District of New York, Charles L. Brieant, Jr., *Judge,* denying judgment notwithstanding the verdict to defendants-appellants-cross-appellees, who were found liable for damages for violating section 10(b) of the Securities Exchange Act, 15 U.S.C. § 78j, and Rule 10b-5; cross-appeal from that part of the order granting judgment notwithstanding the verdict to defendants-appellants-cross-appellees and to defendant-cross-appellee for certain securities law violations. Judgment affirmed on the appeal; reversed as to defendant-cross-appellee only on the cross-appeal; and remanded for redetermination of damages and contribution.

PAUL WINDELS, JR., Windels, Marx, Davies & Ives (Andrew N. Grass, Jr. and Mitchell L. Marinello, of counsel), New York, N.Y., *for Defendants-Appellants-Cross-Appellees.*

I. STEPHEN RABIN, Rabin & Silverman (Benedict Wolf, Stephen D. Oestreich, Wolf Popper Ross Wolf & Jones, and Allan K. Peckel, New York, N.Y., of counsel), *for Plaintiffs-Appellees-Cross-Appellants.*

ROBERT E. MESHEL, D'Amato & Lynch (John M. Burns, III, of counsel), New York, N.Y., *for Defendant-Cross-Appellee.*

OAKES, *Circuit Judge:*

This securities class action was tried on the theory that Solitron Devices, Inc. (Solitron), and certain of its officers, aided and abetted by its accountants, Louis Sternbach & Co. (Sternbach), intentionally issued annual reports and financial statements containing materially false misrepresentations of the company's sales, income, and inventories. The plaintiff class, purchasers of Solitron shares on the public market (the American Stock Exchange), received a general verdict and favorable answers to special interrogatories from a jury in the United States District Court for the Southern District of New York, before Charles L. Brieant, Jr., Judge.

The Solitron defendants appeal from the court's denial of their motion to decertify the class, made on the ground that the named representatives had purchased their shares after the date stipulated as the closing date for their subclass; from the court's decision not to set aside the verdict against them with respect to fiscal year-end financial statements for 1967, 1968, and 1970; from the amount of damages; and from the court's exclusion of certain proffered testimony. The plaintiffs cross-appeal from the court's decision to set aside the verdict against the Solitron defendants with respect to fiscal year-end financial statements for 1972, 1973 and 1974; and from the court's decision to set aside the verdict against Sternbach with respect to the 1967, 1968, and 1970 reports. We reverse the damage award and the decision to grant judgment in Sternbach's favor notwithstanding the verdict, and remand for redetermination of damages and determination of the amount of contribution owed Sternbach by the Solitron defendants.

I. FACTS

Solitron, a manufacturer of electronic semi-conductors, was subject by virtue of its contracts with the United States government to the Renegotiation Act of 1951, as amended, 50 U.S.C. App. §§ 1211-1233. In 1972 the Eastern Regional branch of the United States Renegotiation Board, which enforces the Act's

limits on profits from government contracts, determined that Solitron had realized renegotiable profits of $3.2 million in fiscal year 1967 and $4.4 million in fiscal year 1968.

Solitron, seeking administrative review of the Board's assessment, retained Price Waterhouse & Co. to reexamine its financial statements for 1967 through 1970. Price Waterhouse concluded that those statements, prepared and certified by Sternbach and signed by Benjamin Friedman, Solitron's chief executive officer and largest shareholder, had substantially overstated inventories and sales. In 1973 and 1974 Solitron, seeking to avoid liability for excess profits, disclosed these overstatements to the Renegotiation Board in letters prepared by James S. Trager, a former Sternbach accountant who was then Solitron's assistant treasurer, and James P. Barry, then Solitron's treasurer. In January 1975 the Renegotiation Board issued a final determination that Solitron owed $3.9 million in excess profits from 1967 to 1970, which Solitron is contesting before the Court of Claims. In March 1975 the Securities and Exchange Commission (SEC) brought an action against Solitron for violations of the securities laws, but withdrew the charges the next month pending an investigation by special SEC counsel, who concluded in June 1978 that Solitron had overstated income, but had not done so fraudulently.

Named plaintiffs Howard Sirota (who purchased Solitron shares on June 1, 1971) and Family Restorations (who purchased Solitron shares on April 7, 1971) filed the instant action in March 1975. They contended that the misrepresentations of fact in the company's 1967-70 financial statements that were revealed in the proceedings before the Renegotiation Board demonstrated that defendants Solitron, Friedman, Trager, Barry, and Sternbach had violated section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78(j), and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5. They complained that inventories had been overstated while consignments had been improperly treated as sales, and that Solitron had failed to provide any reserve for probable refunds to the government of renegotiated profits. Their complaint was consolidated with others against Solitron in February 1976.

In February 1976 the named plaintiffs sought certification as representatives of a single class of Solitron investors who purchased common stock during the period beginning February 28, 1967 and ending March 20, 1975, and who thereafter sold at a loss. Subsequently they moved for the designation of three subclass periods: (1) purchasers between May 5, 1967 and June 15, 1971 (which included Howard Sirota and Family Restorations); (2) purchasers between June 15, 1971 and June 22, 1972; (3) purchasers between June 22, 1972 and March 20, 1975. The second of these subclasses was dismissed at trial for want of proof of its claims.

The first subclass was originally certified by the court to include purchasers between May 5, 1967 and June 2, 1971, notwithstanding Solitron's argument that its December 14, 1970 press release announcing losses and inventory write-downs of $7 million, which plaintiffs contended was itself fraudulent, had nullified any effect of the alleged misrepresentations on post-December purchasers of Solitron stock. The parties stipulated at the end of trial that the subclass closed on December 16, 1970. The claims of this 1967-70 subclass prevailed before the jury, and the court, refusing to decertify, granted judgment notwithstanding the verdict to Sternbach but not to Solitron, against whom the court upheld the jury's damage award. The third subclass, certified by the court to include purchasers between June 8, 1972 and January 27, 1975, claimed that Solitron's annual reports for 1972-74, which stated that the Renegotiation Board had assessed Solitron's excess profits but failed to disclose the amounts, were materially false and misleading. Although this subclass also prevailed before the jury, the court granted judgment to the Solitron defendants notwithstanding the verdict.

II. DISCUSSION

A. *Certification of the Class*

The Solitron defendants appeal first from the court's decisions to certify and not to decertify the class represented by

plaintiffs Sirota and Family Restorations. The court certified this subclass on February 13, 1979 to include purchasers of Solitron stock between May 5, 1967 and June 2, 1971 (two days after release of the 1970 annual report). The parties stipulated at the close of trial, however, that December 16, 1970 (two days after the press release reflecting $7 million dollar inventory write-downs) was the closing date for the class. Family Restorations bought its shares on April 7, 1971; Sirota on June 1, 1971. Thus the named plaintiffs were in the subclass as originally certified but out of it as stipulated. The Solitron defendants argue on appeal that the named plaintiffs were not qualified to represent the class. They argue that the court erred, first by not ruling before certification that the December 1970 press release had cut off any injury to the market or to the named plaintiffs from the 1967, 1968, and 1970 financial reports, and second by not decertifying the class when the plaintiffs rested their case without having shown that the December 1970 press release was fraudulent.

1. *Certification*

Judge Brieant certified the subclass as extending until June 2, 1971 on the ground that precertification "inquiry into the merits of a suit" was barred by *Eisen v. Carlisle & Jacquelin*, 417 U.S. 156, 177 (1974). *Eisen* held that Fed. R. Civ. P. 23 gave a district court no authority to hold a precertification hearing on the merits in order to determine whether a suit may be maintained as a class action, and therefore that the lower court's allocation of the costs of class notice to defendants upon a preliminary determination that plaintiffs were "more than likely" to prevail was improper. Class certification motions are not subject to the same standards as motions for dismissal for failure to state a claim or for summary judgment. *See Miller v. Mackey International, Inc.*, 452 F.2d 424, 428 (5th Cir. 1971), *cited with approval in Eisen*, 417 U.S. at 178.

On the other hand, there can be no doubt that it is proper for a district court, prior to certification of a class, to allow discovery and to conduct hearings to determine whether the

prerequisites of Rule 23 are satisfied. "[A] preliminary hearing, addressed not to the *merits* of plaintiff's individual claim, but to whether he is asserting a claim, which, *assuming its merit*, will satisfy the requirements of Rule 23, has never been regarded as violative of the rule stated in *Eisen* . . . ." *Doctor v. Seaboard Coast Line Railroad Co.*, 540 F.2d 699, 707 (4th Cir. 1976) (emphasis in original) (footnote omitted). Indeed a district court may be reversed for premature certification if it has failed to develop a sufficient evidentiary record from which to conclude that the requirements of numerosity, typicality, commonality of question, and adequacy of representation have been met. *See, e.g., Chateau de Ville Productions, Inc. v. Tams-Witmark Music Library, Inc.*, 586 F.2d 962, 966 (2d Cir. 1978).

The issue here falls between the prohibition in *Eisen* and the obligation to rest certification under Rule 23 on something more than the pleadings, *see, e.g., Professional Adjusting Systems of America, Inc. v. General Adjustment Bureau, Inc.*, 64 F.R.D. 35, 38 (S.D.N.Y. 1974) (Gurfein, J.). If the Solitron defendants were arguing that a district court must determine whether the named plaintiffs have a meritorious claim before they can be certified as class representatives, they would plainly be wrong. *See, e.g., Huff v. N.D. Cass Co.*, 485 F.2d 710, 714 (5th Cir. 1973) (en banc) (vacating dismissal of class action on ground that "a class plaintiff who otherwise meets the demands of 23(a) and (b) should not be found to be disqualified solely by an advance determination that his claim is predictably not a winning claim and that, therefore, he cannot adequately represent the class as mandated by 23(a)(4)"). Solitron's argument may be, rather, that some kinds of merits determinations are crucial to determining whether a class action is proper and that in such circumstances *Eisen* poses no bar.

The dictum in *Huff* did suggest that some very basic merits determinations—*e.g.*, whether a named plaintiff suing his employer was ever employed by the defendant, 485 F.2d at 714—may be made prior to certification because they affect whether the named representative has the nexus with the class

required by Rule 23. But the determination involved here is not so basic. No case cited by Solitron supports the proposition that a district court abuses its discretion by certifying when it later appears that plaintiffs lacked a meritorious cause of action. *Doctor v. Seaboard Coast Line Railroad Co.* cites the *Huff* dictum, but only to support the more obvious proposition that the court may properly "identify the character or type *(but not the merits)* of each plaintiff's claim and then . . . determine whether there was a class to which such claim . . . was common and of which it was typical. . . ." 540 F.2d at 708-09 (emphasis in original). In *Doctor* the district court denied class representative status to plaintiffs whose claims were plainly unfit for a class action because they were not shared by any other employees; the court never reached nor thought it proper to reach the merits of the individual claims.

As Judge Gurfein wrote, in making a certification decision, a judge must look somewhere "between the pleading and the fruits of discovery. . . . [E]nough must be laid bare to let the judge survey the factual scene on a kind of sketchy relief map, leaving for later view the myriad of details that cover the terrain." *Professional Adjusting Systems of America, Inc. v. General Adjustment Bureau, Inc.*, 64 F.R.D. at 38. On this view, it would be improper for a district court to resolve substantial questions of fact going to the merits when deciding the scope or time limits of the class. Even a case on which the Solitron defendants rely heavily, *In re LTV Securities Litigation*, 88 F.R.D. 134, 147-48 (N.D. Tex. 1980), supports this view. In that case, Judge Higginbotham decided to close the class period on the date of a press release he regarded as cutting off further claims. He also chose the earlier of two suggested dates for opening the class period, however, thus including in the class those who purchased before the first announcement of restated earnings, stating that while "the court has reservations as to whether plaintiff can make out a claim with regard to the 1975 period, [it] believes that a sufficiently substantial question has been presented such that the class period must commence at the earlier time period proffered." *Id.* at 147. Thus where it was disputed whether

part of a proposed class had a cause of action, Judge Higginbotham certified the class using the more inclusive time period.

Here too, the district court may properly have believed at the time of the decision to certify that there was a substantial question of fact for the jury whether the December 1970 press release had cured the market, barring post-December claims, or was itself fraudulent. Solitron's arguments about that release would then have appeared to be defenses on the merits. The parties' post-trial stipulation to a December 16, 1970 closing date for the subclass, even though it mooted the merits of this issue, cannot be applied retroactively to the pretrial decision to certify.[1] We therefore find that it was proper for Judge Brieant to certify the class as he did, including post-December claimants within the first subclass and allowing Sirota and Family Restorations to act as class representatives.

2. *Decertification*

Although a district court may decertify a class if it appears that the requirements of Rule 23 are not in fact met, it need not decertify whenever it later appears that the named plaintiffs were not class members or were otherwise inappropriate class representatives. Rather, the Supreme Court has stated, "provided the initial certification was proper . . . the claims of the class members would not need to be mooted or destroyed because subsequent events or the proof at trial had undermined the named plaintiffs' individual claims." *East Texas Motor Freight System, Inc. v. Rodriguez*, 431 U.S. 395, 406 n.12 (1977) (citing *Franks v. Bowman Transportation Co.*, 424 U.S.

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1 Judge Brieant stated in colloquy over his jury charges that the named plaintiffs could properly try the case with respect to absent members of the class even though "if hindsight were foresight they shouldn't have been designated as class representatives because of the dates." Plaintiffs argue that they stipulated to the earlier closing date only in order to take out of the case the issue of what damages were sustained by those who purchased Solitron stock between December 16, 1970 and June 2, 1971. It is not now disputed that the named plaintiffs are not themselves entitled to recover as members of the class.

747, 752-57 (1976)). Here certification was proper, and there was no need for decertification. But for the parties' stipulation to December 16, 1970 as the closing date, the question of the effect of the press release (and thus the question of the merit of the named plaintiffs' claims) would have been resolved by the jury verdict. The defendants have not shown that the named plaintiffs failed to represent the class adequately, and the class's victory before the jury might be thought to rebut such an argument in any case. Thus the subsequent definition of the class to exclude the individual named plaintiffs did not require decertification of the class.

B. *Sufficiency of the Evidence*

1. *Fraud by the Solitron Defendants, 1967-70*

The Solitron defendants also appeal from the district court's decision not to set aside the jury's verdict that in the company's financial statements for 1967, 1968, and 1970 they knowingly and materially misrepresented inventories and characterized certain consignments as sales. As the court properly noted, judgment notwithstanding the verdict may be entered only if the evidence, viewed in the light most favorable to the non-movants without considering credibility or weight, reasonably permits only a conclusion in the movants' favor. *Mattivi v. South American Marine Corp., "Huguenot"*, 618 F.2d 163, 167 (2d Cir. 1980); *Simblest v. Maynard*, 427 F.2d 1, 4 (2d Cir. 1970).

a. *Inventory Overstatements*

It is undisputed that the financial statements for the fiscal years ending 1967, 1968, and 1970 materially overstated inventory. The Solitron defendants argue collectively, however, as they did below to the jury and the court, that the inventory recosting that demonstrated the substantial overstatements was not even possible until Solitron had acquired for the first time a computer capability and a sophisticated inventory costing

system based upon newly developed time-and-motion studies recommended by Price Waterhouse in 1972, some two years after the misstatements. They therefore argue that the evidence was insufficient to show scienter, *i.e.*, that there was either actual knowledge of the misrepresentations or a reckless disregard for the representations' truth or falsity. *See Ernst & Ernst v. Hochfelder,* 425 U.S. 185 (1976); *IIT, an International Investment Trust v. Cornfeld,* 619 F.2d 909, 923 (2d Cir. 1980). *See also Rolf v. Blyth, Eastman Dillon & Co.,* 570 F.2d 38, 47-48 (2d Cir.), *cert. denied,* 439 U.S. 1039 (1978), *on appeal from remand,* 637 F.2d 77 (2d Cir. 1980).

We agree with Judge Brieant's post-verdict assessment that there was sufficient evidence of scienter on the part of the company and the individual defendants to sustain the jury verdict against the Solitron defendants for 1967, 1968, and 1970. The jury could properly infer intent from subsequent admissions of misrepresentations, coupled with the defendants' continuous intimate knowledge of company affairs. Solitron benefited from overstating its inventory. From 1966 through 1970 its reported earnings per share surged upward 100%, 50%, 33⅓%, and 20% respectively. The price of the stock followed the reported earnings, enabling Solitron to make numerous acquisitions[2] after a five-for-one split in April 1968. There was direct evidence that Friedman as well as Trager knew that inventory had increased from $1.5 million in 1966 to $2.94 million in 1967, while the inventory-turnover rate declined from 6 times a year to 4.5 times a year; that inventory had increased nearly $5 million in 1968, reducing inventory turnover to less than 2.5 times per year; and that in 1970 inventory had increased by nearly $4 million to $12.5 million, with a turnover rate of only 1.9. The Solitron defendants

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2 These acquisitions included, among others, Felmohn Corp., a manufacturer of microwave devices and electronic instruments; General R-F Fittings, a microwave products manufacturer; a microwave chemicals laboratory; an inventory of digital instruments from Honeywell, Inc.; and certain equipment, patents, and inventory from Electronic Standards Corp. of America.

admitted such overstatements of inventory to the Renegotiation Board in 1974.

There was also direct evidence that accounting procedures at the Riviera Beach, Florida plant, where Solitron carried on its government business, were inadequate to cost inventory accurately. As Barry stated in a letter to renegotiation counsel, the accounting department was "understaffed" and "poorly managed," in keeping with the company's policy at that time: "get the shipment out the back door, get the invoice in the mail to the customer, operate with a minimum overhead, and profits will be generated." Inability to cost certain "highly reliable" and commercial inventory resulted in overstatements in 1967 of $556,000, in 1968 of $1.35 million, and in 1969 of $904,000; there were also raw-material and piece-part costing and other errors of lesser magnitude. Mathematical calculation and addition errors in the year 1968 amounted to $1.05 million.

The evidence of each individual defendant's knowledge of and involvement in the preparation and publication of false financial statements was sufficient to support findings that they each violated Rule 10b-5. Friedman, the head of the company, was in touch with the Florida plant by telephone each day, received regular summaries and reports from the plant, and frequently visited it. He testified at trial that he knew the effect of inventory valuation on profits. There was thus evidence from which the jury could have concluded that he was aware of the company's failure to cost its inventory properly.

Trager, who had been employed by Sternbach until 1971 and who had worked on Solitron audits every year from 1964 to 1969, became comptroller of Solitron in the spring of 1969, assistant treasurer in 1970, and treasurer in 1974. He prepared the reports to the Renegotiation Board showing that profits had been inflated because of overvaluation of inventory, and testified that he knew where to look for the evidence of this overvaluation.

Barry, who was liable for 1970 only, spent fifteen years as an accountant in the Intelligence Division of the Internal Revenue Service before joining the Solitron accounting department at

Riviera Beach in July 1968. He became head of that accounting department in 1969 and treasurer of Solitron in 1970. He went back to the 1967-70 inventory figures for Riviera Beach and showed the inventory overstatements. His documentation helped Price Waterhouse reach its conclusions about inventory overstatements and helped Trager prepare his reports to the Renegotiation Board. Barry admitted to the Renegotiation Board the inadequacies of the Riviera Beach accounting procedures. His testimony at trial showed that he had not verified the 1970 inventory sheets that he certified as properly costed.

Without the overstatements, not only would the earnings per share have been less during the years 1966 through 1970, but the gradient of earnings growth would have been flatter. Indeed in 1970 there would have been a decline in earnings. There was expert testimony before the jury about the effect that the overstatement of earnings and the gradient of earnings growth have on stock prices generally. Overall, we believe there was substantial evidence to support the jury's verdict that the Solitron defendants all had the necessary scienter; the court's refusal to set aside the verdict was proper.

b. *Consignments Reported as Sales*

The Solitron defendants claim further that there was no evidence they committed fraud in reporting three consignment transactions—with Best & Raynor, JFD Electronics Co., and AEL Israel, Ltd.—as sales. We find Judge Brieant's conclusion to the contrary correct. Trager, in preparation for the Renegotiation Board proceedings, went back to documents that had been in his possession in 1969 and 1970, and showed that the transactions classified as sales had in fact been consignments. Friedman negotiated and signed the written contract with AEL Israel, which was specified as a consignment arrangement in accord with the understanding of the principal officers of AEL. Yet over $700,000 of consignments were carried on the books as sales. Although Friedman said he thought the first draft of the agreement provided that the risk would be on AEL, the jury did not have to credit his testimony that he

believed the contract—which he signed and which placed the risk of loss on Solitron—provided for a sale.[3]

2. *Fraud by Sternbach*

On the cross-appeal, the plaintiffs object both to the district court's finding that there was insufficient evidence to support the verdict against Sternbach, and to the court's failure to give the same "recklessness" charge with respect to Sternbach that it gave with respect to the Solitron defendants. The court instructed that actual knowledge by Sternbach of the fraud by Solitron and by the individual defendants was required. The jury found scienter, but the judge set that finding aside. The jury also found, with respect to a pendent state law count, that Sternbach had been negligent, a finding which Judge Brieant set aside and which is not on appeal.

This court has held that proof of reckless conduct meets the requirement of scienter in a section 10(b) claim, *IIT v. Cornfeld*, 619 F.2d at 923. For the imposition of aider and abettor liability under section 10(b), however, we have held that recklessness satisfies the scienter requirement where "the alleged aider and abettor owes a fiduciary duty to the defrauded party," *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d at 44. We have not decided whether recklessness is sufficient in the absence of such a relationship. *Id.* at 44 n.9. At least two district court judges have concluded that recklessness may be sufficient, at least in the case of accountants who know or can reasonably foresee that third parties will rely on their audit or opinion letter. *See Oleck v. Fischer*, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,898 (S.D.N.Y. 1979), *aff'd*, 623 F.2d 791 (2d Cir. 1980); *In re Investors Funding Securities*

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[3] The Solitron defendants also appeal from the court's refusal to admit testimony by Solitron's counsel in the AEL negotiations, which it claimed would show that Friedman believed the AEL transaction to be a sale. We find no error in the court's decision to exclude this evidence under Fed. R. Evid. 403 for lack of probative value, made after taking an offer of proof.

Litigation, 1980 Fed. Sec. L. Rep. (CCH) ¶ 97,717 at 98,763 (S.D.N.Y. 1980).

We have said in dicta in connection with accountants' liability that it is helpful to refer to Judge Goldberg's statement in *Woodward v. Metro Bank of Dallas*, 522 F.2d 84, 97 (5th Cir. 1975):

> When it is impossible to find any duty of disclosure, an alleged aider-abettor should be found liable only if scienter of the high "conscious intent" variety can be proved. Where some special duty of disclosure exists, then liability should be possible with a lesser degree of scienter.

See Edwards & Hanly v. Wells Fargo Securities Clearance Corp., 602 F.2d 478, 484-85 (2d Cir. 1979). *See also IIT v. Cornfeld*, 619 F.2d at 924-25. The dicta also seem to refer to a sliding scale of intent; Judge Gurfein wrote that "something closer to an actual intent to aid in a fraud" is necessary to find a person liable for aiding and abetting, absent a fiduciary relationship, than is necessary to find the principal liable. *Edwards & Hanly*, 602 F.2d at 485. *See also IIT v. Cornfeld*, 619 F.2d at 925. The evidence here at the least would support a finding that Sternbach's conduct—with respect to mathematical errors, consignments recorded as sales, and inventory overvaluation—was highly reckless. In light of our holding below, however, we need not reach the question whether Sternbach, in view of whatever duty it had to disclose, should have been judged under a recklessness standard.

The court granted judgment to Sternbach notwithstanding the verdict on the count of aiding and abetting Solitron's 10b-5 violation, finding "no evidence from which a reasonable juror acting reasonably could conclude that Sternbach aided and abetted the primary securities law violation with the requisite scienter." The court, interpreting the requisite scienter to be actual knowledge of the fraud since Sternbach did not owe a fiduciary duty to the plaintiff investors, found that the evidence at most showed that Sternbach was negligent. The proof did not show, the court wrote, that Sternbach's partner

Edward Cole knew that the Best & Raynor, JFD Electronics, and AEL Israel transactions were consignments, even though "no confirmations were received by Sternbach when requested, no payments were made, no purchase orders were produced and shipments were made close to the end of the fiscal year," and even though a letter from AEL Israel to Cole said the transaction was a consignment. The court found also that even if, as plaintiffs sought to prove, Sternbach performed inadequate and erroneous audits, this did not constitute knowing assitance in the fraudulent overstatement of inventory.

Recalling the stringent standard for granting judgment notwithstanding the verdict, we disagree with the court's conclusion that no reasonable juror could have reached a verdict against Sternbach. First, the court's conclusion that Sternbach lacked actual knowledge is inconsistent with the jury's finding, upheld by the court on defendants' post-trial motion, that Trager—who was employed by Sternbach in 1967, 1968, and early 1969—had actual knowledge of the fraud. Second, evaluation of Cole's credibility, in the face of evidence suggesting he was on notice that the transactions he certified as sales were consignments, was for the jury, not the court. And in light of Sternbach's claims to have performed various costing procedures and tests on Solitron's 1967-70 inventory, the jury might well have concluded that Sternbach knew that its certification of reports overstating inventory was fraudulent. The combination of these facts leads us to the conclusion that there was sufficient evidence for the jury to infer that Sternbach had actual knowledge of fraud in violation of Rule 10b-5.

3. *Fraud by the Solitron Defendants, 1972-74*

On the cross-appeal, plaintiffs also argue that the district court erred in finding that there was no evidence to support the verdict against the Solitron defendants with respect to the financial statements for 1972-74. While these financial statements stated that the Renegotiation Board had determined that Solitron had made excess profits, they did not state that the

amounts involved were $3.2 million for the fiscal year ending February 28, 1967 and $4.4 million for the fiscal year ending February 28, 1968. They stated only that the company was contesting the determinations and that management believed that no significant refunds would be required after renegotiation. Plaintiffs argued below that these statements were materially misleading to investors because they suggested that the renegotiation proceedings had minimal significance.

The judge overturned the jury verdict in plaintiffs' favor because he found that the evidence did not support any conclusion other than that Solitron management, which never believed that the renegotiation assessment was meritorious, had truthfully disclosed to the public. The defendants knew from the Price Waterhouse reports, which they themselves commissioned, that Solitron inventory and income had been materially overstated; they therefore believed that there were no excess profits. Their renegotiation representative, Alexander Kirk, had advised them that the renegotiation assessment had no merit.

While we find in reviewing the record that the question is a close one, we do not think the court erred in setting aside the verdict on this count. There was considerable evidence supporting the view that the defendants reasonably believed that the "box car" numbers used in the government's tentative renegotiation assessment were truly unfounded. The court also noted that to this date the renegotiation claims have never been resolved, suggesting that the government either is extremely inefficient or agrees that the renegotiation claims have no merit. Plaintiffs presented no particular evidence to rebut the defendants' view, but merely argued that the Solitron defendants would not have made the reports they did to the Renegotiation Board unless they expected to be held liable. It is more plausible, however, to infer that they made the reports in the expectation of avoiding liability, in which case their statements to the public were not misleading.

C. *Damages*

Expert witness Gorkiewicz testified for the plaintiffs that when earnings per share were corrected for overvaluation of inventory and sales, Solitron shares were overpriced by 44% in 1967, 72.1% in 1968, not at all in 1969, and 69.6% in 1970. The court submitted to the jury special interrogatory 6a as follows:

> State the percentage, if any, by which you find false or misleading financial statements inflated the market price of Solitron stock.

Period of Overstatement, if any	*Financial Statements For Year Ending*	*Percentage of Inflation, If Any*
5/5/67 - 6/5/68	2/27/67	_____
6/6/68 - 5/22/69	2/27/68	_____
5/27/70 - 6/2/71	2/28/70	_____

The jury responded by filling in for each of the above three periods, respectively, 33%, 54.2% and 52.2%. The judgment entered on April 9, 1981 limited recovery by the members of the class by stating:

> However, the recovery of any purchaser, exclusive of interest, shall not exceed the actual loss of that purchaser based on the market price of Solitron stock on October 31, 1979, that being the date on which the class was closed and following which no opt-out was authorized, or the actual loss based on actual selling price of the stock if sold prior to October 31, 1979.

All parties are agreed that the cut-off date of October 31, 1979 is wrong and that the cut-off date for opting out is irrelevant. The date should be December 16, 1970, when the defendants ceased the "pollution" of the market place. *Harris v. American Investment Co.*, 523 F.2d 220 (8th Cir. 1975), *cert denied*, 423 U.S. 1054 (1976). Thus the plaintiffs are precluded from

claiming a larger award based on declines in price after that date and the defendants from awarding a smaller amount based on increases in price thereafter. *See Voege v. Ackerman*, 364 F. Supp. 72 (S.D.N.Y. 1973).

The Solitron defendants argue that plaintiffs' damage theory is illogical and has no support in this circuit because it does not relate the alleged overpricing either to actual market behavior or to disclosure events, and because it treats the stock as overvalued by a constant percentage for each year. But as the district court pointed out, the year-long periods presented to the jury in Special Interrogatory 6a were stipulated to be accurate time periods, corresponding to the figures outlined by Gorkiewicz. And while it seems odd that the calculations are for full years and vary sharply from the last day of one to the first day of the next, these are only hypothetical constructs which had to be made rather arbitrarily since there were no disclosures until December 1970. Each year was an era and the point in time between years an epoch.

We agree with the court below that with respect to 1967 and 1968, the damage question was one of fact, resolved satisfactorily by the jury through 25% reductions in Gorkiewicz's estimates. But we think that the Solitron defendants are correct that the jury's finding that the stock was overvalued by 52.2% in 1970 cannot stand. After the December 1970 disclosure of the inventory write-downs, the market in the stock declined immediately only 11% and then rose. This actual response of the market must be taken into account in determining the damages for all or part of the year 1970. *See Shapiro v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, 495 F.2d 228 (2d Cir. 1974); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969). This is a matter we leave to the sound discretion of the trial judge, because there might have been other favorable developments in the company or in the market place offsetting the harmful effects of the disclosure.

Solitron also argues that the district court erred because it failed to consider the drastic market decline of 1970, citing *Rolf v. Blyth, Eastman Dillon & Co.* and *Feit v. Leasco Data*

Processing Equipment Corp., 332 F. Supp. 544, 586 (E.D.N.Y. 1971). But these cases and the rule they announced have no bearing in a case like this in which a stock purchaser has purchased his stock at a price higher than he would have paid had true financial statements been made. *Rolf* involved the decline in value of a portfolio of one investor improperly advised by an investment adviser who was recklessly aided and abetted by the investor's broker. *Feit* involved a fraudulent registration statement suit under section 11, with statutorily determined damages expressly excluding damages caused by "independent forces," 332 F. Supp. at 586. Here the issue is the amount by which each class member was defrauded on the date of his purchase. Any subsequent decline in the market had no effect on that fraudulent sale.

D. *Contribution*

Sternbach argues that if liable, it is entitled to contribution from the Solitron defendants. We agree. Courts in this circuit have permitted contribution in section 10(b) cases even though section 10 of the Securities Exchange Act, unlike sections 9 and 18, does not expressly provide therefor. *See Tucker v. Arthur Anderson & Co.*, 646 F.2d 721, 727 n.7 (2d Cir. 1981); *Seymour v. Bache & Co.*, 502 F. Supp. 115, 119 (S.D.N.Y. 1980); *Alexander & Baldwin, Inc. v. Peat, Marwick, Mitchell & Co.*, 385 F. Supp. 230 (S.D.N.Y. 1974); *Globus, Inc. v. Law Research Service, Inc.*, 318 F. Supp. 955, 958 (S.D.N.Y. 1970), *aff'd*, 442 F.2d 1346 (2d Cir.),*cert denied*, 404 U.S. 941 (1971). In *Tucker*, a section 10(b) case, this court noted that "under the securities laws, a person who has defrauded the plaintiff in violation of those laws may be liable for contribution to another person who has similarly defrauded the plaintiff." 646 F.2d at 727 n.7. The amount of contribution we leave to the sound discretion of the trial judge.

Judgment affirmed in part, reversed in part, and remanded.

Judgment of the Second Circuit

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

#81-7357, 7367, 7377

At a stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, on the nineteenth day of February one thousand nine hundred and eighty-two.

Present:

HON. J. EDWARD LUMBARD,
HON. JAMES L. OAKES,
HON. AMALYA L. KEARSE,
Circuit Judges.

HOWARD SIROTA, FAMILY RESTORATIONS, A Partnership, ROBERT J. BERK and BRUCE M. UMLAS, on behalf of themselves and all others similarly situated,
Plaintiffs-Appellees-Cross-Appellants,

and

UNION CARBIDE CORPORATION,
Plaintiff-Intervenor-Appellant,

v.

SOLITRON DEVICES, INC., BENJAMIN FRIEDMAN, JAMES S. TRAGER, JAMES P. BARRY,
Defendants-Appellants-Cross-Appellees,

LOUIS STERNBACH & CO.,
Defendant-Cross-Appellee,

Appeal from the United States District Court for the Southern District of New York

This cause came on to be heard on the transcript of record from the United States District Court for the Southern District of New York, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the judgment of said District Court be and it hereby is affirmed in part, reversed in part and the action be and it hereby is remanded to said district court for further proceedings in accordance with the opinion of this court.

A. Daniel Fusaro, *Clerk*

by s/ ARTHUR HELLER
Arthur Heller,
Deputy Clerk

Judgment of the United States District Court for the Southern District of New York

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

75 Civ. 1369 (CLB)

HOWARD SIROTA,

Plaintiff,

—against—

SOLITRON DEVICES, INC., et al.,

Defendants.

JUDGMENT

WHEREAS:

This is a consolidated class action brought on behalf of certain purchasers of stock of Solitron Devices Inc. against Solitron Devices Inc., Benjamin Friedman, James P. Barry and James S. Trager and Louis Sternbach & Co.

This action was tried to a jury which returned a general verdict for the plaintiff class, and also answered special interrogatories with respect to liability and damages, pursuant to Rule 49(b) Federal Rules of Civil Procedure.

Defendants Solitron, Friedman, Barry and Trager moved for a judgment n.o.v., pursuant to Rule 50(b), Fed. Rules Civ. Procedure, or in the alternative for a new trial pursuant to Rule 59(a) Fed. Rules Civ. Procedure. Defendant Sternbach also moved for judgment n.o.v. as well as for an Order granting it contribution over on its cross-claims against Soli-

tron, Friedman, Barry and Trager. Defendants' motions have been briefed and argued before this Court and the Court rendered a decision on March 6, 1981 with respect to defendants' motions, granting them in part and denying them in part.

IT IS HEREBY ORDERED AND ADJUDGED:

1. That defendants Solitron, Friedman, Trager and Barry's motions for judgment n.o.v., or in the alternate for a new trial as to the jury verdict of liability and damages with regard to plaintiffs' claims concerning misrepresentations of inventory, sales and profits, contained in the Solitron financial statements for the fiscal years ending February 28, 1967, February 28, 1968 and February 28, 1970 are hereby denied, and these defendants are hereby adjudged to be liable jointly and severally for the damages set forth below as a percentage of inflation of the purchase price to any purchaser of the common stock of Solitron Devices, Inc. who purchased during the following time periods and either retained or sold said stock after December 16, 1970, except that defendant Barry is adjudged to be liable only with respect to the period May 27, 1970 and through December 16, 1970:

Period of Overstatement	*Percentage of Inflation*
May 5, 1967–June 5, 1968	33%
June 6, 1968–May 27, 1969	54.2%
May 27, 1970–Dec. 16, 1970	52.2%

plus pre-judgment interest from the date of purchase at 6% per annum and for a joint bill of costs to be taxed by plaintiffs against the above defendants only. However, the recovery of any purchaser, exclusive of interest, shall not exceed the actual loss of that purchaser based on the market price of Solitron stock on October 31, 1979, that being the date on which the class was closed and following which no opt-out was authorized, or the actual loss based on actual selling price of the stock if sold prior to October 31, 1979.

2. That defendant Sternbach's motion for judgment n.o.v. as to the jury verdict of liability and damages against defendant Sternbach under Rule 10b-5 and for negligent misrepresentation with regard to plaintiffs' claims concerning misrepresentations of inventory, sales and therefore profits, contained in the Solitron financial statements for the fiscal years ending February 28, 1967, February 28, 1968 and February 28, 1970 is granted, and it is adjudged that all relief shall be denied as against defendant Louis Sternbach & Co., without costs to any party.

3. That the motions of defendants Solitron, Friedman, Trager and Barry for judgment n.o.v. as to the jury's verdict of liability and damages with regard to plaintiffs' claims concerning Solitron's failure to disclose in the financial statements for the fiscal years ending February 28, 1972, February 28, 1973 and February 28, 1974, the amount of contingent liability which had been determined by the United States Renegotiation Board to be owed by Solitron is hereby granted without costs to any party.

4. That all cross-claims and demands for indemnity and contribution among and between the defendants are hereby denied without costs to any party.

5. The Court hereby reserves jurisdiction over all matters relating to the administration and processing of class members' claim forms, including without limitation, the hearing of objections to such claims, and fixing and allowing counsel fees and expenses out of the class recovery and the entry of any further judgment or judgments as may be necessary to effect and enforce the rights of the parties.

6. Pending appeal, or further order of this Court made after notice and hearing, enforcement of this judgment is hereby stayed, and this action is transferred to the Suspense Docket of this Court to be restored to my docket on motion following appellate finality.

Dated: New York, New York
April 9, 1981

CHARLES L. BRIEANT
Charles L. Brieant
U. S. D. J.

Judgment Entered 4/9/81

RAYMOND F. BURGHARDT
Clerk

Memorandum and Order of the District Court Denying Motion for Judgment Notwithstanding the Verdict or for a New Trial

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

75 Civ. 1369 (CLB)

HOWARD SIROTA, et al.,

Plaintiffs,

—against—

SOLITRON DEVICES, INC., et al.,

Defendants.

MEMORANDUM AND ORDER

BRIEANT, J.

This class action, brought on behalf of purchasers of shares of Solitron Devices, Inc. against the company, Solitron Devices, Inc. (hereinafter Solitron), its officers, Benjamin Friedman, James P. Barry and James S. Trager, and its accountants, Louis Sternbach & Co. (hereinafter Sternbach), was tried to a jury which returned a general verdict for the plaintiff class, and also answered Special Interrogatories, pursuant to Rule 49(b), Fed. R. Civ. P. Familiarity therewith is assumed. Defendants Solitron, Friedman, Barry and Trager have moved for judgment notwithstanding the verdict, pursuant to Rule 50(b), Fed. R. Civ. P., or in the alternative, for a new trial, pursuant to Rule 59(a), Fed. R. Civ. P. Defendant Sternbach has also moved for judgment notwithstanding the verdict as well as for an order granting it contribution-over on its

cross-claims against the co-defendants. The contribution claims were tried to the Court without a jury.

The principal allegations of the amended complaint were based on violations of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j and Rule 10b-5 promulgated thereunder, 17 C.F.R. 240 10b-5. Specifically, the case was tried on the theory that Solitron, the stock of which is publicly traded, and the individual defendants violated Rule 10b-5(2) and polluted the market, by intentionally issuing annual reports and financial statements which contained material false representations as to the company's sales, income, inventory and accounts receivable, as well as material omissions as to the true financial condition of the company. Defendant Sternbach was alleged to be an aider and abettor of the primary securities law violation. A pendent state claim of common law negligence against the defendant Sternbach was also tried to the jury.[1]

For convenience, we set forth the background of the litigation and consider how it arose. Defendant Solitron, is a semi-conductor manufacturer and by virtue of its government contracts, a small proportion of its business primarily involving its branch at Riviera Beach, Florida, was subject to the Renegotiation Act of 1951, as amended. The Act, derived from legislation in effect originally during World War II to prevent a repetition of claimed "war profiteering" believed to have been committed during World War I by so called "merchants of death," limited the amount of profits a contractor or subcontractor could earn on government contracts and provided for an administrative recapture of any excess to be determined after completion of the contracts. In 1972, the United States Renegotiation Board "determined," administratively, that Solitron had realized renegotiable profits, subject to recapture, of $3,200,000 attributable to fiscal year 1967 (Pltf. Ex. 69) and renegotiable profits of $4,400,000 attributable to fiscal year 1968 (Pltf. Ex. 70).

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1 The amended complaint also pleaded pendent claims of common law fraud which the Court dismissed. (Tr. 1415).

Following the usual procedure in such matters, Solitron sought administrative review of this assessment. It retained Mr. Alexander Kirk who testified at trial. Mr. Kirk is not a lawyer; he describes himself as a renegotiation consultant. His professional work includes the representation of government contractors at the investigatory and administrative levels, to assist them in avoiding or minimizing recapture. Advised by Mr. Kirk, Solitron, in order to obtain a more favorable determination of its liability, retained Price Waterhouse & Co. to investigate, and prepare reports for Solitron (Pltf. Ex. 9 & 9a). The reports, which are not audits, indicated that the Board's determination of excess profits may have been in error, because it relied on overstated sales and inventories in the certified financial statements of Solitron for those years. These financials, included in Solitron's annual report, were prepared by Sternbach from Solitron's books and records and were signed by Friedman. Plaintiffs contended at trial that the misrepresentations of fact in the corporation's certified financials disclosed in the Price Waterhouse reports and in a letter written by defendant Trager, acting for Solitron, to the Renegotiation Board (Pltf. Ex. 115) taken together, demonstrated significant prior violations by the defendants of the federal securities laws.

At the time of the initial renegotiation assessment, Solitron disclosed in its financial statements that a liability assessment had been rendered, and was being contested but failed to disclose the amount so assessed. The disclosure reads as follows:

> "A portion of the company's business is subject to The Renegotiation Act of 1951, as amended. Determinations of excessive profits in fiscal years 1967 and 1968 have been made by The Eastern Regional Renegotiation Board but are being contested by the company. The Statutory Board is presently reviewing The Regional Board's determinations. The fiscal years 1969 and 1970 are being reviewed by The Regional Board but such review is not expected to be completed until the earlier years are settled.

> Management believes that . . . no significant refunds will be required on renegotiable business."

(Annual Report for fiscal year 1972, Pltf. Ex. 25.) Similar disclosures were made in the annual reports for fiscal years ending 1973 and 1974. (Pltf. Ex. 26 and 8.)

On this basis, plaintiffs alleged that this constituted a material omission in violation of Rule 10b-5. The latter claim was not asserted against defendant Sternbach because it was not Solitron's accountant during this period.

The plaintiff class of purchasers of Solitron securities during the 1967-75 period was divided into two subclasses[2] to correspond to the time periods during which the alleged misrepresentations or omissions were made in the Solitron financial statements. The first subclass consists of those persons who purchased Solitron securities from May 5, 1967 to December 16, 1970[3] and who thereafter either sold said stock at a loss or continue to hold said stock. The claims of this class submitted to the jury concerned misrepresentations of inventory, sales and therefore profits, contained in the Solitron financial statements for the fiscal years ending February 28, 1967, February 28, 1968 and February 28, 1970. Although plaintiffs also asserted a claim based upon misrepresentations of inventory in the financial statements for the fiscal year ending February, 1969, that claim was dismissed by the Court. (Tr. 1513-14).

The second subclass consists of those persons who purchased Solitron securities from June 8, 1972 to January 27, 1975 and

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2 As originally certified, the plaintiff class was divided into three sub-classes. See, Memorandum Decision, February 13, 1979. The claims of the third sub-class were based upon claimed misrepresentations and/or omissions in the financial statements for fiscal year ending February 1971. Plaintiffs abandoned this claim at trial for want of proof and therefore it was not submitted to the jury. (Tr. 1435).

3 This sub-class originally included persons who had purchased Solitron shares during the period extending to June 2, 1971. At the close of trial, the parties stipulated that the first class would close on December 16, 1970, two days after the press release which disclosed the write-offs Solitron was going to make. (Tr. 1517-18).

who thereafter either sold that stock at a loss or still hold it. The claim submitted to the jury on behalf of these shareholders was based on the failure to disclose in the financial statements for the period including fiscal year ending February 28, 1972 through fiscal year ending February 28, 1974 the amount of contingent liability which had been determined by the United States Renegotiation Board to be owed by Solitron. Because the claims of each subclass depend upon distinct misrepresentations or omissions in the financial statements, the Court will consider them separately in determining the post-trial motions.

1. *Subclass No. 1*

We turn first to consider the claims of the first subclass, as to which plaintiffs contended that the financial statements for the fiscal years 1967, 1968 and 1970 contained misrepresentations as to the amount of inventory, and that certain transactions between Solitron and AEL Israel, between Solitron and Best & Raynor, and between Solitron and JFD Electronics were characterized improperly as sales when they were merely consignments of unsold goods. The jury answered Special Interrogatories in the affirmative as to the individual elements of this claim and also stated the percentage by which it found the misrepresentations had inflated the market price of Solitron securities for each of the three years specified.

The Solitron defendants now seek to challenge the jury verdict on various bases. They claim that:

> "(1) there was insufficient evidence before the jury to sustain its answers to the special interrogatories and its verdict, (2) the verdict is contrary to the weight of the evidence and (3) at no time did any of the named plaintiffs have a claim with respect to Solitron's books and records for the period ending December 16, 1970. Defendants also move for a new trial pursuant to Rule 59(a) on the ground that it was prejudicial error for the Court to refuse to permit the introduction of the proffered testimony of Bernard Malina, Esq., the attorney who repre-

sented Solitron in the AEL Israel transaction, concerning matters relating to Benjamin Friedman and scienter." (Memo of Law, filed Nov. 12, 1980, at 1-2).

Supplementary affidavits of various persons connected with the AEL Israel transactions were submitted by the Solitron defendants in support of the motion for a new trial, apparently on the basis of newly discovered evidence. Defendant Sternbach has filed an answering affidavit.

Defendant Sternbach also moves to set aside the verdict of the jury, as it pertains to the claims of the first subclass, on the ground that there was insufficient evidence to sustain the determination of its liability as an aider and abettor or for common law negligence under New York law.

Evidence Presented at Trial.

The defendants' motions must be evaluated against the applicable standard. In order to enter judgment notwithstanding the verdict, the trial court must find that "the evidence is such that, without weighing the credibility of the witnesses or otherwise considering the weight of the evidence, there can be but one conclusion as to the verdict that reasonable men could have reached." *Simblest v. Maynard,* 427 F.2d 1, 4 (2d Cir. 1970) (citations omitted). In this case, the evidence must be viewed in light most favorable to the plaintiffs and they must be given the benefit of all the favorable inferences which the evidence fairly supports. *Mattivi v. South African Marine Corp.,* 618 F.2d 163, 167 & n.3 (2d Cir. 1980); *Lebrecht v. Bethlehem Steel Corp.,* 402 F.2d 585, 589 (2d Cir. 1968).

A motion for a new trial pursuant to Rule 59(a), Fed. R. Civ. P., is addressed to the discretion of the trial judge, whose duty it is to assure that there has been no miscarriage of justice. *Bevevino v. Saydjari,* 574 F.2d 676, 684 (2d Cir. 1978). Before granting a new trial, the Court must find that the weight of the evidence is plainly against the non-moving party. *Id.*

The jury was charged that the plaintiff was required to prove the following five elements by a preponderance of the evidence

before it could find a primary violation of Rule 10b-5 by Solitron or any of the individual defendants:

> "The first element is that in connection with the purchase or sale of Solitron Devices securities, namely stock, the defendants made representations of fact. In connection with this element you can treat the annual reports and the press releases, which are in evidence in this case, as representations of fact.
>
> The second element is that these representations or any one or more of them contained one or more untrue statements of fact or omitted facts which were necessary to make the statement not misleading in light of all the circumstances then existing.
>
> The third element is that the misrepresentations or omissions must have been material. . . .
>
> The fourth element must be that the defendants, or the defendant whose case you are considering, acted with scienter. . . .
>
> The fifth element, which must be shown is that the defendants' conduct caused damage to the class of persons who purchased Solitron stock during the period in which the misrepresentations were outstanding or the omissions were withheld from the public. That damage would be present if it be found by you that the misrepresentations or omissions, if there were any, caused the market price of Solitron stock to be inflated over what it would have been had there not been any Rule 10b-5 violation." (Tr. 1583-84.)

The Solitron defendants do not dispute that the financial statements for the fiscal years ending 1967, 1968 and 1970 contain overstatements of inventory. Nor do they contest that the contract between Solitron and AEL whereby AEL agreed to distribute Solitron products in Israel was, as it most clearly states, a consignment arrangement and that the treatment of goods consigned thereunder as sales included on the 1970 financials was in error. Neither do they contest the jury finding

that the misrepresentations taken as a whole for these three years were material.[4] They do contend, however, that the evidence at trial was insufficient to establish that any of the individual defendant officers sued or Solitron itself acted with the requisite scienter, and that it did not support the jury's determination of damages.

The Solitron defendants have failed to establish that they are entitled to a judgment notwithstanding the verdict or a new trial on either basis.

In order to satisfy the element of scienter, plaintiff was required to prove that the defendant whose case is being considered participated in the preparation or dissemination of the financial statements with actual knowledge of the misrepresentations or with a reckless disregard for their truth or falsity. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976); *IIT, An International Investment Trust v. Cornfeld*, 619 F.2d 909, 923 (2d Cir. 1980); *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1300-02 (2d Cir. 1973).

The misrepresentations in the financial statements for the years ending 1967, 1968 and 1970 were based on overstatements of inventory and improper accounting for consignments as if they were sales. Solitron admitted these overstatements in its presentation to the Renegotiation Board in 1974. The report to the Renegotiation Board was submitted by Mr. Friedman, and contained memoranda from the other officers of the company, Mr. Trager and Mr. Barry. There is no question that as of 1974, the three individual defendants and Solitron had actual knowledge of the misrepresentations sufficient to satisfy the scienter requirement if the financial statements had been issued at that time. The issue is whether the defendants possessed the actual knowledge at the time the financial state-

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4 Defendants do argue that the major portion of the disparity between the original financials and the later "accurate" figures was attributable to ordinary error, resolved after the event by Solitron's later acquired computer capability and a subsequent time and motion study used to verify inventory costs. They contend that the remaining amount is not material. The factual issues, discussed *infra*, were resolved by the jury, adversely to defendants.

ments were issued. The defendants argue now, as they did before the jury, that the overstatements of inventory were not known until the late 1970's and could not have been discovered without the time and motion study, and its computer capability, both of which postdated the financial statements.

They also argue that they did not learn that certain "sales" were actually "consignments" until 1974. These arguments were made to the jury and are merged in the jury verdict. The question of intent is not capable of exacting proof. It is a question of fact, peculiarly within the scope of the jury function to determine from all the evidence presented and drawing all logical inferences. There was sufficient evidence presented as to the intent of each individual defendant, and as to corporation, Solitron, to sustain the jury verdict. The case was proved principally through the admissions of the defendants made to the Renegotiation Board and documents contemporaneous with the fraud. Plaintiffs proved that Solitron and the individual defendants engaged in an intentional effort to exaggerate or "hype" the sales and profits of Solitron and thereby mislead prospective stock purchasers. A reasonable jury could reject their claims at trial that they relied on the expert advice of their accountants. Reasonable jurors could find that the Solitron defendants purposely contrived to inflate the company's financials. They could also find that they knowingly completed and gave to Sternbach false inventory certificates and Sternbach questionnaires in order to ensure that the inflated sales and inventory figures would go undetected.

Although the goods shipped to AEL Israel were booked as "sales," the plain language of Solitron's contract provided that AEL Israel was to be merely a distributor of Solitron semi-conductor devices, and specifically referred to the transaction as a consignment.

> "2. This Agreement shall apply during its term to all *consignments* of merchandise made by Solitron to A.E.L. during the term of this Agreement. A *'consignment'* within the meaning of this Agreement, shall exist when

> Solitron shall deliver merchandise which is received by A.E.L. and which Solitron shall designate, in writing, as consigned merchandise. Said *consigned* merchandise shall hereinafter be referred to as the 'merchandise'. Title to the merchandise shall not pass to A.E.L." (Pltf. Ex. 9) (emphasis added.)

This contract, which was concealed from the auditors, also provided that each invoice pertaining to this agreement would state *on its face* that the merchandise was being shipped on consignment:

> "Each shipment of merchandise under this Agreement shall have a Consignment Number of the series 001-100 attached thereto. Solitron shall place the following endorsement on each invoice of consigned merchandise:
>
> > 'The within merchandise bearing Consignment Number ____ is delivered by Solitron Devices, Inc. to A.E.L. Israel Limited, pursuant to an Agreement dated January 27, 1970.' "

None of the invoices for goods shipped to AEL Israel contained this required endorsement, nor did they indicate, in any other manner, the true nature of the transaction. Each on its face appeared to record a sale. No auditor who examined *any* of the invoices would be apprised that it was a consignment rather than a sale. The jury could also find that the "sales" to AEL Israel were booked as such at a point in time close to the end of the fiscal year 1970, in an attempt to hype the sales, and thereby the profits of the company. The jury could apply its logic, its common sense and experience to find that the last sales booked in any fiscal year are the most profitable, because the overhead and administrative expenses of a company have already been covered. The jurors could conclude on the totality of the evidence that the $1,053,468 recorded as sales to AEL Israel, in itself approximately 4% of the year's total sales of $30.9 million, was a material misrepresentation and inflation of earnings. Mr. Friedman himself was the "salesman" in

charge of the AEL account (Tr. 420). This was not the first time that Solitron included consignment shipments as sales in order to hype its profits. Plaintiffs proved that in 1969 consignment shipments to Best & Raynor (in the United Kingdom) amounting to $443,780 were improperly included as sales. Similarly, in 1969 and 1970, shipments to JFD Electronics, a company run by Mr. Robert Dressler (with whom Mr. Friedman was acquainted and with whom he spoke about the transaction), in the amount of $468,634 were also booked as "sales." The jury could consider this evidence of prior, similar acts as well as the paper trail left by the AEL transaction in determining the intent of the defendants. An inference of fraud is compelling.

The jury had sufficient evidence before it to support a conclusion that the Solitron defendants intentionally polluted the market with false and fraudulent sales and profit figures, and only disclosed the true information when it became helpful to Solitron in its Renegotiation dealings to do so. Therefore, the Court rejects the defendants' contention that there was insufficient evidence on this claim to support the jury verdict. Nor do I find that the verdict is so contrary to the weight of the evidence so as to require a new trial.

Each defendant has also argued that his individual involvement in the preparation and dissemination of the false financial statements and his individual knowledge is insufficient to sustain a finding that he intentionally violated Rule 10b-5. This is plainly not the case.

Mr. Trager participated in the preparation of the financial statements as a member of the Sternbach audit team for the fiscal years ending 1967 and 1968 and was the comptroller of the Tappan Division of Solitron from June 1969. He currently serves as Treasurer of Solitron. Mr. Trager coordinated the presentation made to the Renegotiation Board seeking a reduction in the assessment levied against Solitron. When these company officials learned that the inventory write-down and resulting financial loss it had incurred in 1971 could not be applied for Renegotiation purposes to reduce the profits earned in previous years, they attempted to show that the

profits of earlier years had been overstated when reported, and were "phony."

It is important to note that when the time came to dispute the amount of profit, Mr. Trager knew where to look for evidence. Trager testified that it was he who informed the Renegotiation Board that the inventory for the years 1967 to 1970 had been overvalued. He admitted that the suggestion that the revaluation of inventory would yield overpriced inventories in earlier years was his. It was not an endeavor undertaken pursuant to a suggestion of the Renegotiation Board (Tr. 245). In the presentation to the Renegotiation Board, the build-up of inventory was cited in support of the claim that inventory was overstated. If this be evidence of overstatement, it was equally available when the original financial statements were prepared. He also prepared information to submit to the Renegotiation Board, admitting that the consignment transactions with three companies, AEL Israel, Best & Raynor and JFD Electronics were recorded improperly on the books of Solitron as sales in the year of shipment. To substantiate this argument before the Renegotiation Board, he relied on letters he received from each of these companies indicating that each was acting as a distributor on a consignment basis. (Tr. 164, 165). Although he had already received the letters from Best & Raynor and JFD Electronics, he, nevertheless, in January 1970, prepared and signed an internal control questionnaire for Sternbach and in response to an inquiry as to whether consignments were under inventory control, checked "not applicable." (Pltf. Ex. 32). He received a copy of the letter sent from AEL Israel to Mr. Cole at Sternbach prior to the certification of the financials and issuance of the 1971 annual report but after the closing date of fiscal year 1971. Mr. Trager had these three letters in 1970-71. In 1974, he contended for the first time that they showed the transactions involved were consignments. Mr. Trager was the source of the information in the Price Waterhouse Report dealing with the consignments. (Pltf. Ex. 9). Although he testified that he came to this conclusion only after obtaining a legal opinion in 1974, the jury could infer that he already knew these transactions were consignments and

lied about the state of his knowledge. Here again, he knew where to look.

Mr. Barry was charged as a defendant only in respect to Solitron financials for the year ending February 1970, during which he was employed as the head of its accounting department. In preparation for the Sternbach audit, he certified that the inventory for fiscal year 1970 was taken at his direction and that each item was priced at the lower of cost or market. (Tr. 528, 529). These figures were then provided to Sternbach, and formed the basis for the financial statements and Sternbach's opinion. Mr. Barry testified that he did not spotcheck the inventory sheets for accuracy in 1970, nor did he attempt to ascertain the method by which the items on the sheets were "costed" (Tr. 526). He testified further that no person to his knowledge attempted for Solitron to verify the inventory figures for this period. In fact, in a letter written to the Renegotiation Board he admitted the inadequacies of the accounting procedures employed (Pltf. 101). This was evidence from which the jury could conclude that Mr. Barry acted with scienter when he certified the inventory to Sternbach for fiscal year ending 1970.

The Solitron defendants contend in their Reply Brief filed on this motion, that the amount attributable to 1970 recosting errors was minimal and that the materiality requirement has not therefore been met. This argument presupposes that the jury found that the figures contained in Solitron's 1974 presentation to the Renegotiation Board were unavailable in 1970. Clearly this latter contention was not accepted by the jury, and properly so.

Mr. Friedman was the president, chief executive officer and the overall manager of Solitron. The jury could find that he participated in the preparation or dissemination of the financial statements in the annual reports issued over his signature and did so with scienter. He was in constant communication with the Riviera Beach division and was aware of its sales. He also knew that the inventory figures were increasing, and knew the effect this had on the profits of the company. He testified at trial that "What's written in the [Price Waterhouse] report I

agree with." (Tr. 491). That report on inventory overvaluation cited the buildup on inventory as evidence of the fact.

With respect to the consignment transactions, Mr. Friedman personally negotiated and signed the written contract with AEL Israel, which plainly specified a consignment arrangement (Pltf. Ex. 9). The testimony of Dr. Reibman, the principal of AEL Israel, showed that the written and executed agreement accorded with his understanding of the arrangement. Mr. Freidman contends, however, that the first draft of the agreement provided that the risk of loss would be on AEL, indicating that the transaction was a sale. He testified that he believed the final contract continued to provide for a sale. The jury could conclude from the evidence presented that Mr. Friedman knew the difference between a consignment and a sale, although he testified to the contrary. And the jury could conclude that he read the AEL contract before he signed his name to it, and thereby learned that it provided for distribution on a consignment basis, and that risk of loss was placed on Solitron.

Neither do I find any prejudicial error resulting from the exclusion of Mr. Malina's proffered testimony, which would warrant the grant of a new trial. Mr. Malina was the attorney for Solitron who participated in the drafting of the AEL Israel consignment contract. His testimony was offered at trial on the issue of whether Mr. Friedman acted with scienter. An offer of proof was taken outside the hearing of the jury, as contemplated by Rule 103, F.R.Evid., and the proof was excluded, pursuant to Rule 403, F.R.Evid. as lacking probative value. The proferred testimony of Mr. Malina failed to demonstrate, as defendant now contends, that Mr. Friedman was unaware that the contract he signed varied from the initial understanding that he now claims he reached with AEL, or that he was unaware of the difference between a consignment and a sale, or that he relied on the expert advice of his attorney in treating this substantial transaction as a sale.

The offer of proof demonstrated that the signed contract differed from the original or first draft of a proposed agreement between the parties. This is not unusual. Beyond that, the

most that Mr. Malina's testimony showed was his inability to recall the surrounding details. The lack of any probative value on the question of scienter is apparent from the testimony given. With respect to the original meeting between Mr. Friedman and AEL representatives, Mr. Malina testified:

> Q. Was anything said with respect to the kind of relationship, if any, that was to exist between Solitron and AEL Israel? A. *None that I can recall.* (Emphasis added) (Tr. 1191).

Mr. Malina yielded no information relevant to Mr. Friedman's knowledge or intent at that time:

> Q. Was there any discussion between you and Mr. Friedman prior to the time you participated in drafting relating to the subject of who would assume the risk of loss with respect to the goods that were going to be shipped? A. *I don't recall* a conversation directed to that particular point.
>
> Q. Are you saying that there was no such conversation? A. I can't say with absolute certainty that the conversation never took place but *I don't recall any.*
>
> Q. Do you remember what the initial drafts of the agreement provided with respect to who would assume the risk of loss, whether it was Solitron, AEL or some other party? A. I believe in the initial draft it was AEL that was to assume the risk of loss. (Tr. 1192-93) (Emphasis added).

Finally, Mr. Malina was questioned about the executed agreement:

> Q. Did there come a time that the drafts that were exchanged changed that provision so that the risk of loss was to be borne by Solitron? A. Yes, I believe that is so.
>
> Q. Did you discuss the change with Mr. Friedman? A. I don't recall a *specific* discussion with Mr. Friedman on that point.

Q. Did you ever discuss with Mr. Friedman that the final agreement that was executed provided that the merchandise was to be consigned to AEL Israel? A. *I don't recall a specific conversation* on that point.

Q. Did you ever tell Mr. Friedman that the agreement provided that the merchandise was to be consigned to AEL Israel? A. *I don't recall the specific conversation.* I can—

(Tr. 1194).

* * * * *

Q. Did you tell me a few minutes ago [outside the courtroom] that you never told Mr. Friedman that the agreement provided that the merchandise was to be consigned? A. Yes. That is essentially so, yes.

THE COURT: Were you under oath when you told him that?

THE WITNESS: No.

THE COURT: Do you understand you are under oath now?

THE WITNESS: Yes.

THE COURT: Are you testifying truthfully now?

THE WITNESS: Yes, I am.

THE COURT: Forget it, Mr. Morrison.

Q. Did you ever explain to Mr. Friedman what the word 'consignment' means in law? A. *I don't recall any such conversation,* no.

Q. Are you saying that you didn't tell Mr. Friedman?

THE COURT: He doesn't recall any such conversation.

A. I don't recall. (Tr. 1195-96) (Emphasis added).

This testimony does not demonstrate "Friedman's contemporaneous state of mind." (Def. Memo. of Law at 27). It does not show that Mr. Friedman believed the transaction to be a sale or even that he believed the original draft agreement terms had not been changed when the final agreement was presented

for his signature. It does not prove any advice given to him by his attorney upon which he could be said to have relied. It shows nothing except that attorney Malina has a poor memory, and, like many potential witnesses, he will tell a litigant what the litigant wants to hear, so long as he is outside the courtroom and not under oath. There is no substance to defendants' claim of prejudice from the exclusion of this basically irrelevant testimony.

The Solitron defendants have submitted affidavits from three individuals involved in the arrangements surrounding the AEL contract in support of their motion for a new trial. These specifically concern a trip to Israel in April 1971 by Mr. Friedman and Mr. Cole. The affidavits of Dr. Riebman, Mr. Dor and Mr. Ravillan attempt to show that Mr. Cole of Sternbach was apprised of the true nature of the relationship between Solitron and AEL in April 1971, a date prior to the certification of the financial statements for fiscal year ending in February 1971. They also show that Mr. Friedman was not a party to these discussions about the financial arrangements. This appears to be the basis for the argument that Mr. Friedman never knew the true nature of the transaction and instead relied on Mr. Cole, his accountant.

Dr. Riebman, the president of AEL Israel, says only that (Affidavit of Dr. Riebman, sworn to November 4, 1980):

> "Mr. Cole reviewed the financial aspects of the relationship between Solitron and A.E.L. Israel with Gideon Dor, the vice president of finance for A.E.L. Israel and Rony Ravillan, the Israeli attorney who was advising the parties. As I recollect, Mr. Friedman did not concern himself with the financial or legal aspects of the matter but was fully involved in the engineering and sales discussions. To my recollection, after our initial meetings I did not discuss the form of transaction with Mr. Friedman, his interest apparently being in the volume of anticipated business and market opportunities."

This is so much doubletalk and collected buzz words. He provides no specific information about the discussions.

Gideon Dor's affidavit, sworn to November 12, 1980, was specific. He now states that Mr. Cole was advised specifically that this transaction was a consignment:

> "Mr. Cole and I discussed the accounting transaction upon the sale of any of the semiconductor merchandise from the bonded warehouse. These discussions were summarized in my letter to Mr. Cole dated May 7, 1970 attached hereto as Exhibit 'A'. Mr. Cole and I discussed that the arrangement between AEL and Solitron was that of a consignment, and that any remittance to Solitron would only take place upon a sale of the consigned merchandise to a third party and subsequent collection."

Rony Ravillan (Affidavit sworn to November 12, 1980) recounts the same conversation but with less specificity:

> "In April 1970, several Solitron personnel visited Israel. Among the Solitron personnel were Benjamin Friedman, Solitron President and other people, which to the best of my recollection included Mr. Edward Cole, the Accountant for Solitron. Among the subjects discussed with Mr. Cole were the legal procedures involved in the handling and accounting for money due Solitron upon the sale of the merchandise in the bonded warehouse and the setting up of Solidev Israel Ltd. and since the merchandise was received on consignment it was presumed that payments for the merchandise (by the respective customers) would only be made after a sale of said merchandise from the bonded warehouse."

The opposing affidavit of Mr. Cole, sworn to January 12, 1981, directly contradicts this claim:

> "I did not discuss with Mr. D'Or any of the matters referred to in his affidavit. Specifically, I deny discussing 'the nature of the financial arrangements between A.E.L. and Solitron'; the maintenance of the merchandise in a bonded warehouse in Israel; visiting any bonded warehouse in Israel; discussing 'the accounting transaction

> upon the sale of any of the semiconductor merchandise from' any bonded warehouse; 'that the arrangement between A.E.L. and Solitron was that of a consignment, and that any remittance to Solitron would only take place upon a sale of the consigned merchandise to a third party and subsequent collection.
>
> I did not meet with Mr. Ravillan at all and deny having any discussions with him. Moreover, I was not a member of any group with whom Mr. Ravillan had any discussions. He certainly did not inform me that merchandise would be held in a bonded warehouse or that it was received on consignment or that payment would only be made after sale of any merchandise."

Cole states that he met with Mr. Dor who showed him AEL's bookkeeping system. This system, he contends, was appropriate for recording actual purchases only. He also stated that he visited the AEL facility. Cole observed "open racks in their salesroom containing Solitron merchandise in addition to other electronic devices of other companies," and concluded "[t]his was not a bonded warehouse by any stretch of the imagination." These statements were consistent with his testimony at trial concerning the April 1970 trip to Israel. (Tr. 775-78, 1368-69).

The disparity between these affiants cannot be resolved without an evidentiary hearing to determine credibility. Assuming the accuracy of the affidavits submitted on behalf of defendants, however, I do not believe they warrant the grant of a new trial on the issue of liability of the Solitron defendants.

No showing has been made that this evidence was not known to defendants at the time of trial, or was not discoverable with due diligence, thereby justifying a grant of a new trial on the ground of newly discovered evidence. See, 6A J. Moore, Federal Practice, ¶ 59.08(3) (2d ed. 1979). In fact, at the hearing on this motion, the defendants' attorney stated that he had decided, presumably for valid tactical reasons, to forego cross-examination of Mr. Cole on this point. Nor do I find it likely that the evidence, if admitted, would change the verdict.

The Solitron defendants also contend that there was insufficient evidence to sustain the jury determination of damages. On the issue of damages, plaintiffs presented the expert testimony of two witnesses, Mr. Lieberman and Mr. Gorkiewicz. Mr. Lieberman computed the effect that public disclosure of correct figures, assuming them to be such, set forth in the Price Waterhouse Reports would have on earnings per share of Solitron stock during each year in issue. Mr. Gorkiewicz then gave his opinion as to what the market price of Solitron would have been if the correct earnings per share had been disclosed. His opinion was based on his conclusion that proper market valuation of Solitron shares was best obtained by utilizing the earnings approach, that is, looking at earnings per share and the rate of growth. The verdict returned by the jury adopted Mr. Gorkiewicz's figures reduced by twenty-five percent. Defendants now argue that (1) the jury applied the expert's estimates to the wrong years; (2) there was no factual basis for his theoretical estimates; and (3) the jury's verdict constitutes a impermissible compromise verdict. First, defendants argue that Mr. Gorkiewicz's estimates were based on a year-long period extending from the beginning to the end of the fiscal year which the periods set forth for the jury were determined by the dates the annual reports were issued. The year-long periods presented to the jury in Special Interrogatory No. 6a were stipulated to be the accurate time periods. There is no question that the parties considered these periods to correspond to the figures opined by Mr. Gorkiewicz. (See, Tr. 1413). A review of the transcript reveals that Mr. Gorkiewicz's estimates of inflation of market price were given in response to a question based on the same time period as appeared in the Special Interrogatories. The defendants' second point was argued to the jury and is merged in the jury verdict. The defendants presented the expert testimony of Mr. Rogalski to demonstrate that the earnings approach utilized by Mr. Gorkiewicz to value the stock was erroneous. They argued to the jury that investors do not purchase stock on the basis of earnings and that, in fact, after a brief period the price of Solitron continued to rise once

the disclosure took place in 1971.[5] This presented an issue of fact which was resolved by the jury. The third contention in regard to the damage determination is that the verdict must be set aside as an impermissible compromise because the jury reduced Mr. Gorkiewicz's estimate of damages by twenty-five percent across the board. It is true that a jury may not compromise on liability. Therefore, when a cause of action is brought to recover an undisputed sum of liquidated damages, a partial damage award will be set aside as a compromise verdict. See, *Banco Popular de Puerto Rico* v. *Deliz*, 407 F.2d 1388 (1st Cir. 1969); *National Fire Insurance Co. of Hartford*

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5 Defendants argued that historical price/earnings ratio has little to do with the market price of stock of a publicly traded company. Mr. Richard Rogalski testified that the approach used by Mr. Gorkiewicz was wrong. He analyzed the market price of Solitron throughout the applicable period using "efficient market approach" which assumes that publically available information is reflected in the market price. By using this approach and comparing the fluctuations in price for Solitron with similar companies in the industry and with a broad based market index, he concluded that the overstatements in inventory and the disclosure of the inventory write-down in December 1970 had no impact on the financial "return" of Solitron.

A large section of the financial press and the investing public do appear to pay attention to the historical earnings of a company and believe they are reflected in the current prices of stocks. Investment literature usually contains this information and it is readily available in the daily financial papers. It is a common belief that, all other things being equal, if earnings increase, the price of the stock will increase. While sophisticated investors might reject this theory as unproven, and still other such investors believe one can select the best investments by treating the entire exchange listing of publicly traded stocks as a dartboard, the jury could find that the overinflated earnings were a material misrepresentation to the investing public at large which affected price directly. If an investor made a decision to invest at an asking price on the basis of earnings that were wilfully inflated, the market would be polluted. Investors were entitled to rely on a market in receipt of all relevant material and truthful information. It is too late to argue that historical earnings reported do not affect stock prices, and are therefore not "material" to investment decisions, valid though the argument might be in a market where all buyers are experts. And it is also too late to contend that market pollution of this sort cannot be regarded by a jury as the proximate cause of financial loss.

v. *Great Lakes Warehouse Corp.*, 261 F.2d 35 (7th Cir. 1958). When the amount of damages is in dispute, the jury is free to compromise on the issue of damages and adopt the figure it perceives as fair.

> "In many cases of unliquidated damages it is quite proper for a jury to compromise the differences of the parties where amount of the verdict is not so grossly inadequate as to render it a farce. Commendable as such practice may be, however, a jury cannot compromise an issue of liability."
>
> *National Fire Insurance Co. of Hartford, supra* at 38.

In this instance, there was no sum of liquidated damages nor a stipulated amount of damages. The jury was free to accept plaintiff's theory but to reduce the plaintiff's figures to compensate for exaggeration.

Named Class Representatives

The Solitron defendants also challenge the verdict by arguing that no named plaintiff is, or ever was, a proper class representative. They therefore ask the Court to decertify the class pursuant to Rule 23(c)(1), dismiss the individual claims of the named representatives and enter judgment in defendants' favor.

As originally certified, the first sub-class consisted of "those persons who purchased Solitron stock during the period from May 5, 1967 to [June 2, 1971] and who thereafter either sold said stock at a loss or still hold said stock." Memorandum Decision, February 14, 1979, at 3-4. The closing date of the class correspondence to a date two days after the publication of the 1970 annual report which the plaintiffs stipulated correctly represented the fiscal 1970 sales and income.[6]

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[6] Plaintiffs originally requested certification of a class that would include purchasers to and including June 15, 1971, a period of two weeks after the publication of the Solitron Annual Report. The Court determined that the period required by the public marketplace to absorb fully the contents of the reports was not that long and the period was shortened to two days.

The appropriate closing date of this sub-class was in dispute throughout this litigation. The plaintiffs' claim was that the misrepresentations in the financial statements caused the market price of the shares to be inflated until the date on which full disclosure was made. They maintained that the appropriate closing date was the date when the market had assimilated the annual report for fiscal year 1971 which disclosed an inventory write-down of approximately Ten Million Dollars, that is, June 2, 1971. The Solitron defendants, however, contended that no shareholder who purchased shares after December 16, 1970 could have been damaged by this inflation because on December 14, 1970 Solitron issued a press release which disclosed an inventory write-down of approximately Seven Million Dollars. Recognizing that the Supreme Court has held in *Eisen* v. *Carlisle & Jacquelin*, 417 U.S. 156 (1974) that the Court on a Rule 23 motion lacks power to "conduct a preliminary inquiry into the merits of a suit in order to determine whether it may be maintained as a class action," the Court certified the first sub-class as extending until June 2, 1971. Two of the named plaintiffs were purchasers of shares during this period. Family Restorations, Inc. purchased 400 shares in April, 1971; Howard Sirota purchased 25 shares in June, 1971. The plaintiffs tried the class claims on behalf of all purchasers within these time periods who continued to hold their shares after June 2, 1971. Because plaintiffs conceded that at least partial disclosure had occurred in December 1970, there was a question of fact for the jury to resolve as to the effect of that disclosure on any alleged inflation of the market price. The Court, therefore, requested, prior to the submission of the case to the jury, that the parties draft an appropriate interrogatory to submit to the jury on this question. In lieu of this interrogatory, the parties advised the Court that they had stipulated that the class period would close on December 16, 1970.

> "THE COURT: Gentlemen, as I understand it, rather than modifying the interrogatory to be given to the jury as I invited you to agree upon a form of doing so, and I

believe I did indicate if you couldn't agree I would modify it some way myself, but I understand that rather than agreeing on a modification or asking the Court to make one you have agreed on some other solution of the problem which is created by the press release of December 1970.

Would you be good enough to state your understanding on the record?

MR. OESTREICH [Plaintiff's counsel]: I think the understanding is that it is hereby stipulated and agreed by and among the parties that the class period which begins after the publication of the annual report of Solitron for the year ending February 28, 1967 will end upon the publication of the December 14, 1970 third quarter shareholder release by Solitron.

And in conformance with your Honor's prior ruling, giving two days for the absorption of that information in the public marketplace, and said information having been published in the Wall Street Journal on December 16th, it is hereby stipulated that that class period will end on December 16, 1970.

THE COURT: Is it so stipulated?

MR. MORRISON [Counsel for Solitron defendants]: Yes, it is.

THE COURT: Do you want the interrogatories amended as they now stand to put that as the cutoff date? Did you expect me to deal with that press release in any way—

MR. RABIN [Plaintiff's counsel]: No.

THE COURT: —on the charge?

MR. RABIN: No, not at all. Just leave the interrogatory the way it is.

THE COURT: All of you are in agreement?

MR. MORRISON: Yes." (Tr. 1517-18).

The effect of this stipulation was to place the class representatives outside the class period. They are not, therefore, members of the class entitled to recover. The defendants argue that there was no proof of any damage, that is market inflation,

occurring after December 16, 1970 and that the named plaintiffs are not, and never were, proper class representatives. The basis of this argument is that their claims are not typical of those of the class as required by Rule 23(a)(3), Fed. R. Civ. P. and that the "case or controversy" requirement of Article III of the United States Constitution is not therefore met. No contention is made that the class representatives, or their attorneys, failed to provide adequate representation for the class interests.

The Court adheres to its earlier decision and finds that the class was properly certified on February 14, 1979. The analysis of that determination will not be recounted here. The question remaining is whether the class should be decertified because proof at subsequent trial, and/or the stipulation of their own counsel, barred the individual claims of the class representatives. Although the individual claims were barred, a viable controversy existed between the members of the class, as modified, and the defendants. When the case was submitted to the jury, there was a sufficient adverse relationship between the members of the class and the defendants to satisfy the case or controversy requirement of Article III of the United States Constitution and to allow them to succeed to the adversary position theretofore held by the class representatives. See *Franks* v. *Bowman Transportation Co., Inc.*, 424 U.S. 747 (1976); *Sledge* v. *J. P. Stevens & Co., Inc.*, 585 F.2d 625 (4th Cir. 1978), *cert. denied*, 440 U.S. 981 (1979).

The class was certified prior to trial, the class claims were tried to the jury and the class members had an interest adverse to the defendants. I do not conclude that any benefit would result from a dismissal at the close of the trial, simply because the proof at trial demonstrated that the individual claims of the class representatives were barred.

In *East Texas Motor Freight System, Inc.* v. *Rodriguez*, 431 U.S. 395 (1977), the Supreme Court vacated a judgment where the Court of Appeals certified a class on appeal after the district court had dismissed the individual claims of the class representatives. The Court recognized that a different situation

would exist if the class had been certified properly before trial and the class claims tried to the jury (431 U.S. at 406, n. 12):

> "Obviously, a different case would be presented if the District Court had certified a class and only later had it appeared that the named plaintiffs were not class members or were otherwise inappropriate class representatives. In such a case, the class claims would have already been tried, and, provided the initial certification was proper and decertification not appropriate, the claims of the class members would not need to be mooted or destroyed because subsequent events or the proof at trial had undermined the named plaintiffs' individual claims. See, *e.g.*, *Franks* v. *Bowman Transportation Co.*, 424 U.S. 747, 752-57; *Moss* v. *Lane Co.*, 471 F.2d 853, 855-56 (CA4)."

I find, therefore, that the class as modified may succeed to the adversary position of the named representatives. The defendant's motion for judgment notwithstanding the verdict on the basis is denied.

Liability of Accountants as Aiders and Abettors

Louis Sternbach & Co. was found liable to the plaintiff class as an aider and abettor of the primary security law violation. Three essential elements must be proved to establish aiding and abetting liability [*IIT, An International Investment Trust* v. *Cornfeld*, 619 F.2d 909, 922 (2d Cir. 1980)]:

> "(1) the existence of a securities law violation by the primary (as opposed to the aiding and abetting) party;
>
> (2) 'knowledge' of this violation on the part of the aider and abettor; and
>
> (3) 'substantial assistance' by the aider and abettor in the achievement of the primary violation. [Citations omitted]."

With regard to the existence of the primary violation, the defendant Sternbach contends that the original figures in the

financial statements were accurate and contests the validity of the Price Waterhouse Reports. Although Sternbach points out that these documents were admitted into evidence against the Solitron defendants only, they did form the basis of establishing the primary violation. The jury found that the Solitron defendants had violated Rule 10b-5. This Court has determined that there was sufficient evidence to support their determination to withstand the defendants' judgment n.o.v. motions. The first element, the violation of the securities law by the primary party, has been proved.

Defendant Sternbach argues that its actions in connection with the financial statements do not constitute substantial assistance. Defendant contends that mere inaction or a failure to disclose cannot be regarded as substantial assistance. Sternbach audited the books and records of Solitron and certified the financials for its Annual Report to shareholders. This does not constitute mere inaction. If this was done with actual knowledge of the primary fraud, I think it would be sufficient to establish substantial assistance. This need not be decided, however, because I find that there was no proof at trial from which reasonable jurrors acting reasonably could conclude that Sternbach acted with scienter.

In order to prove that an aider and abettor acted with scienter, plaintiffs were required to prove that the accountants rendered substantial assistance with actual knowledge of the primary fraud. *Edwards & Hanly* v. *Wells Fargo Securities Clearance Corp.*, 602 F.2d 478, 484 (2d Cir. 1979) *cert. denied*, 444 U.S. 1045 (1980); *accord, IIT, An International Investment Trust* v. *Cornfeld, supra*. Proof of negligence is insufficient. *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1978). Although this Circuit has held that proof of recklessness will suffice when the aider and abettor owes a fiduciary duty to plaintiff, *Rolf* v. *Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 47 (2d Cir. 1978, *cert. denied*, 439 U.S. 1039 (1978), no argument has been made that the accountants owed a fiduciary duty to the plaintiff investors. See also, *Competitive Associates, Inc.* v. *Laventhol Krekstein Horwath & Horwath*, 478 F.Supp. 1328, 1342 (S.D.N.Y. 1979).

The Court finds insufficient evidence in the record to establish that the defendant Sternbach acted with actual knowledge of the primary security violations. Plaintiff argues first that Mr. Cole, a partner of Sternbach & Co., knew that the AEL transaction was a consignment, and yet certified the financial statements which included it as a sale. As evidence thereof, they point to the letter of May 7, 1970 addressed to Mr. Cole and sent by Gideon Dor of AEL Israel setting forth his understanding of the arrangement between the two parties. Cole testified that the letter did not correspond to his understanding of the relationship between the parties. There was no proof of knowledge. Each of the individual defendants denied knowledge that the transactions were consignments and the position of the defendant Solitron, in its own documents and those prepared for Sternbach, indicated that Solitron management characterized this transaction as a sale. Plaintiffs also argue that the jury could infer that Sternbach had knowledge that the AEL Israel, Best & Raynor, and JFD Electronics transactions were consignments because no confirmations were received by Sternbach when requested, no payments were made, no purchase orders were produced, and shipments were made close to the end of the fiscal year. Assuming the validity of plaintiffs' contentions and that Sternbach should have been put on notice of the irregularity and should have obtained independent evidentiary proof rather than relying on management, all that would be proven is that the defendant acted negligently. An inference from these facts that the defendant Sternbach must have been aware that the sales were actually consignments and that the financials were therefore misleading is not permissible. See *McLean* v. *Alexander,* 599 F.2d 1190, 1199 (3d Cir. 1979).

With respect to the valuation of inventory, plaintiffs point to the fact that the accountants testified that standard accounting procedures were followed but that there was no independent evidence in the work papers. Their argument is that if the plaintiffs followed the proper acounting procedures, they knew of the fraud. Alternatively, they argue that if they did not follow the procedures set out in their own programs, they

knowingly certified documents without any knowledge of their truth or falsity. The plaintiffs argument cannot succeed. In whatever terms it is couched, the plaintiffs are essentially arguing that there were mistakes in the financial statements and that if Sternbach had performed its auditing and accounting functions properly, the errors would have been revealed. This does not equal knowing assistance of a fraud. It may constitute negligence and if extreme enough, recklessness, but it does not satisfy the scienter requirement of Rule 10b-5. The jury may not infer that the accountants acted knowingly merely from the presence of the incorrect figures. See *Jacobson* v. *Peat, Marwick, Mitchell & Co.*, 445 F.Supp. 518, 523 (S.D.N.Y. 1977).

There was overwhelming uncontroverted evidence in favor of the defendant Sternbach. There was no evidence from which a reasonable juror acting reasonably could conclude that Sternbach aided and abetted the primary securities law violation with the requisite scienter. Judgment notwithstanding the verdict is granted to defendant Sternbach on this claim.

Negligence of Defendant Sternbach.

The jury also received a pendent claim under New York law alleging negligence by the accountants and returned a verdict on this claim for the plaintiff class against Sternbach. Sternbach now moves to set aside this verdict because there was insufficient proof of negligence to sustain the verdict and because plaintiffs, by virtue of their relationship with the negligent actor, or perhaps more properly, their lack of relationship, are not entitled to recover under New York law.

The jury was charged that plaintiff must prove that Sternbach failed to exercise the degree of care which a reasonably prudent accountant would exercise in the same circumstances, that the negligent statements inflated the market price of Solitron and were therefore the proximate cause of damage to the plaintiff class (Tr. 1602-03). The jury found that the accountants had acted negligently in certifying the financial statements of Solitron for the years 1967, 1968 and 1970. If

this Court had been acting as trier of the facts, it would have determined the issue of negligence otherwise.

The function of a certified public accountant generally is to examine the books and records, contracts and relevant papers of the client and express an opinion as to whether its financial statements being certified fairly reflect the financial status of the corporation and its operations as of the period certified, and also to determine whether the accounting facts are stated accurately and in compliance with generally accepted accounting principles consistently applied. While it is always hoped that certified public accountants, in connection with their audits, will detect mistakes, frauds, embezzlements or other forms of crookedness in the company, as this Court has previously observed "no sheriff can prevent all felonies in his bailiwick, and the law does not so require." *Rich* v. *New York Stock Exchange,* 379 F.Supp. 1122, 1126 (S.D.N.Y. 1974), *rev'd. other grounds* 522 F.2d 153 (2d Cir. 1975).

Some evidence of failure to follow standard auditing practices was introduced to the jury. Whether the accountants acted negligently was a question of fact upon which reasonable persons could differ. It was within the jury's function to determine these facts. There was not such a failure of proof to require a judgment notwithstanding the verdict, or a new trial on this point. I decline to disturb the jury's findings of fact.

However, for the reasons stated below, I conclude that judgment must be entered for defendant on this claim as a matter of law.

Plaintiffs are not parties who under New York law are entitled to recover damages from Sternbach because of its negligent representations found in Solitron's certified financials. A plaintiff may never recover for negligence unless the defendant owes that plaintiff a duty to use reasonable care. In the seminal New York case dealing with the liability of accountants to third parties, *Ultramares Corp.* v. *Touche,* 255 N.Y. 170, 183 (1931), the New York Court of Appeals declined to extend the auditor's duty owed to its employer under its contract of employment to a plaintiff who loaned the audited company money in reliance on the certified balance sheet,

although the defendant knew the balance sheet would be shown to prospective creditors and had, in fact, furnished the company 32 certified copies to be handed out to lenders and suppliers. The Court stressed that the accountants did not know the plaintiff was a specific company to whom the balance sheet would be shown. The Court held, therefore, that the accountants owed no duty, absent fraud,[7] to "the indeterminate class of persons who, presently or in the future, might deal with the [audited] company in reliance on the audit." The rationale was that this expansion of the concept of duty would expose the accountants to limitless liability.

> "If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class. The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences." 255 N.Y. at 179-80.

That decision did not preclude recovery by all third party plaintiffs in similar situations. The *Ultramares* Court distinguished *Glanzer* v. *Shepard,* 233 N.Y. 236 (1922) which had allowed a buyer to recover from a defendant who negligently certified the weight of goods sold. The Court concluded that the law imposed a duty toward the plaintiff buyer because the defendant public weigher had been made aware that the certificate was prepared for plaintiff's sole benefit, and had furnished it directly to the plaintiff. The law of New York,

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[7] The *Ultramares* Court recognized that third parties could recover from accountants when the cause of action was based on fraud, rather than mere negligence. In *State Street Trust Co.* v. *Ernst,* 278 N.Y. 104 (1938), the Court held that third parties could prove fraud by demonstrating "heedlessness and reckless disregard of consequences," rather than deliberate intention. Such heedlessness and reckless disregard was not proved as to Sternbach.

therefore, appeared to impose a duty to use reasonable care only when the third party and the certificate's intended use were identified. Otherwise, the duty to use due care was limited to those entitled by contract or privity.

In *White* v. *Guarente*, 43 N.Y.2d 356, 361 (1977), the New York Court of Appeals most recent pronouncement on accountants' liability to third parties, that Court extended the accountants' duty to a known and settled group whom the accountant "must have known . . . would necessarily rely on or make use of the audit." The Court cited *Glanzer* and held that this duty was imposed by law and not limited by contract or privity. *Id.* at 362. While *Glanzer* had held that a plaintiff whose reliance was specifically foreseen could recover, *White* extended this concept to permit recovery by members of a limited class whose reliance should have been foreseen. Plaintiff, one of twenty limited partners was therefore permitted to recover from the accountants who were hired by the general partners to audit the books and prepare the partnership tax returns, "not as a mere number of public, but as one of a settled and particularized class among the members of which the report would be circulated for the specific purpose of fulfilling the limited partnership agreed upon arrangement." *Id.* at 363.

In the instant case, plaintiffs, as an amorphous group of those who traded in the public securities market during the years at issue, were not members of a "settled and particularized class" when the financial statements were certified. Their individual and collective identity was unknown to Sternbach. Although the defendants knew that investors would rely on the financial statements, the group of potential investors was and is almost as widespread as the general public. Although the *White* Court may have expanded the scope of accountants' negligence liability, it distinguished but did not overrule *Ultramares*. We do not agree with plaintiffs that the rationale and policy considerations supporting *Ultramares* have so changed with time, that the New York Court of Appeals would overrule that decision if presented with these facts today. But see *Dworman* v. *Arthur Andersen & Co.*, N.Y.L.J., May 1, 1980

(Sup.Ct., N.Y. Co.). Plaintiffs are plainly within the proscriptions of the *White* decision.

> "Indeed, the import of Ultramares is its holding that an accountant need not respond in negligence to those in the extensive and indeterminable investing public-at-large." *White* v. *Guarente*, 43 N.Y.2d at 361.

Judgment notwithstanding the verdict is entered for defendant Sternbach on the negligence or professional malpractice claim, solely as a matter of law.

2. *Second Sub-Class.*

The second sub-class consists of investors who purchased Solitron stock during the period extending from June 8, 1972 to January 27, 1975. Their Rule 10b-5 claim, asserted only against the Solitron defendants, was based on the Solitron Annual Reports for the fiscal years ending 1972, 1973 and 1974. Plaintiffs allege that the statements in these Reports were materially false and misleading because they failed to disclose the *amount* of excess profits assessed by the Renegotiation Board.

The facts on which this claim is based are undisputed. Solitron received notification in 1972 that the Renegotiation Board had determined that it owed $3,200,000 in excess profits for fiscal year ending February 28, 1967 and $4,400,000 attributable to the fiscal year ending February 28, 1968. In its Annual Reports for fiscal years 1972, 1973 and 1974, Solitron disclosed the fact that liability assessments had been rendered, mentioned no amounts, and informed the reader that management was contesting the assessment, and believed no significant refund would be required when the matter was fully adjudicated. See p. 4, *supra*. The jury returned a verdict for the plaintiff class and determined that this failure to disclose had inflated the market price of Solitron shares by 28.2 cents per share.

The defendants now move to set aside the verdict. Defendants argue that there was no duty to disclose the precise amount of the claim and that no material fact was withheld from the investing public.

The only proof offered by plaintiffs in support of this claim was the assessments rendered by the Renegotiation Board, the receipt of this information by Trager, and the failure to disclose the precise amount of the assessment.

Solitron management never for one moment believed that the Renegotiation claim asserted by the Government had any merit, or presented any real risk of loss to the corporation. They knew that income and profits of Solitron, together with its sales and inventory, had been materially overstated during the years 1967 through 1970. To demonstrate this fact, they commissioned the making of the Price Waterhouse Reports. As has been noted in our discussion of the claim asserted by the first sub-class based on the misrepresentations in the financial statements for those years, defendants knew exactly where to look to find the information to support the Price Waterhouse Reports. Price Waterhouse did not conduct an *audit* of the books and records of Solitron for the prior years. It merely compiled a *report* from materials furnished by management which tended to demonstrate that there were no excess profits.

The federal securities laws do not require management to "disclose" in its public reports, facts or information which are conjectural, speculative, or which management itself does not reasonably believe to be true. In the circumstances of this case, defendants reasonably believed that the "box car numbers" attached to the Government's tentative Renegotiation assessment were so unfounded as to be immaterial and absurd.

Solitron management here disclosed truthfully to the public, and to the shareholders that such a claim was outstanding, that they were resisting the claim, and that they did not regard it as having any material effect. To handle the claim, they retained Mr. Alexander Kirk, who had previously disposed of a similar claim made against a Solitron subsidiary by the Renegotiation Board in a manner satisfactory to management. Although Kirk was not a lawyer, the Court concludes that he understood

Renegotiation claims and had been effective over many years in representing clients in resisting such claims. Mr. Kirk advised management in writing in effect that the claims had no merit, in his professional judgment.

Any juror acting reasonably should have concluded that Solitron management reasonably believed Kirk's conclusions and opinions on the point. Disclosure was adequate.

If more is to be said about the Renegotiation claims, we observe that Solitron was first notified of the assessments in 1972. As of the date of trial, and for all this Court knows at the present date, although involving a rather substantial amount of money, the claims have never been resolved. This gives rise to two possible conflicting inferences. The first is that the Executive Branch of the United States Government does not know what it's doing, is extremely inefficient, and cannot even collect a claim against Solitron for sums in excess of Seven Million Dollars going back to 1967 and 1968, and pending administrative resolution since 1972. An equally possible inference, slightly more charitable, is that the bureaucrats who asserted this federal claim against Solitron know perfectly well that it has no merit, and for that reason they have not pursued it. We like to think that our Government functionaries are sincerely motivated, are honest, and pursue valid claims against citizens and taxpayers in favor of the Government, or at least claims they consider valid. When claims in large dollar amounts such as these are allowed to slumber for almost a decade, that fact suggests that the Renegotiation claims have no merit, and indeed that those charged with the duty to pursue the claims know that they have no merit, but are too timid to put their chop on a paper withdrawing the claims.

For all of these reasons, this Court is convinced that no reasonable juror, acting reasonably, could find a violation of Rule 10b-5, or any other relevant statute or rule of law in connection with Solitron's reporting to its shareholders of facts concerning its outstanding Renegotiation claims.

The motions of Solitron, Trager, Barry and Friedman for judgment notwithstanding the verdict is granted, so far as it

pertains to the claims of the second sub-class. The motion of Sternbach for judgment notwithstanding the verdict is granted on both claims. In all other respects, the motions are denied.

Cross-Claims and Demands for Indemnity and Contribution.

The cross-claims of the defendants were reserved to the Court at trial. (Tr. 1644-45). The Court has not yet received a full submission of these claims. It would seem, however, that the Court's analysis of the motions for judgment n.o.v. suggests that there is no basis for granting any contribution or indemnity to any party seeking such relief.

Sternbach, because of its negligence as found by the jury should not be entitled to indemnity from Solitron for the costs of defense of this lawsuit. Solitron is not entitled to any indemnification or contribution from Sternbach, because the fraud took place at a high level in Solitron management, and is therefore imputed to the corporation. Neither the corporation, nor its officers, nor the individual defendants were relying on Sternbach in the matter. In point of fact, Sternbach was gulled by false representations made to it by Solitron. As between an intentional wrongdoer, Solitron, on the one hand, and a negligent wrongdoer, Sternbach, on the other, this Court perceives no basis for indemnity or contribution. Recognizing that counsel has not yet been given the opportunity to make further submissions which were promised, unless some aspect of the issues relating to the cross-claims has been omitted from consideration by the Court, the Court is prepared to regard them as properly denied.

Settle an interlocutory judgment on five (5) days notice of settlement, or preferably on waiver of notice. The judgment shall adjudicate the rights of the named parties and shall adjudicate also the rights of the absent class members, reserving jurisdiction for the purpose of processing claim forms and hearing objections to such claims, if any, and also to fix and allow legal fees and disbursements out of the class recovery.

Upon the entry of that judgment the Court will, if so requested, consider whether all or part of the issues therein resolved should be certified for an interlocutory appeal pursuant to 28 U.S.C. § 1292(b).

So Ordered.

Dated: New York, New York
March 6, 1981

CHARLES L. BRIEANT
Charles L. Brieant
U.S.D.J.

Memorandum Decision of Hon. Charles L. Brieant dated February 13, 1979

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

75 Civ. 1369-CLB

HOWARD SIROTA, et al.,

Plaintiffs,

—against—

SOLITRON DEVICES, INC., et al.,

Defendants.

MEMORANDUM DECISION

BRIEANT, *J.*

By Memorandum and Order filed October 29, 1976, the Court, at the request of counsel for a defendant in this case, held in abeyance a motion for a class certification pending further pre-trial discovery. Thereafter, the action was referred to Honorable Sol Schreiber, then a United States Magistrate, to (a) schedule and supervise further pre-trial discovery bearing upon the delineation of the proposed class or classes; (b) hear and report with respect to the pending motion to declare a class; and (c) for all other pre-trial purposes. A further hearing on the class action motion was held before me on October 26, 1978. Familiarity with the October 29, 1976 Memorandum decision and with all prior proceedings in these cases is assumed.

At various hearings held before me, the amended consolidated complaint has been amplified orally as a result of continuing pre-trial discovery. It presents allegations that the defendants, Solitron Devices, Inc. ("Solitron"), its officers and directors and the accounting firm of Louis Sternbach and Co. ("Sternbach") had carried out an alleged scheme and common course of conduct to issue to the investing public a series of inaccurate, false and misleading financial statements and reports which contained material misrepresentations and omissions of fact. These alleged misrepresentations and omissions had the effect, it is claimed, of inflating the market price of Solitron stock during the period from 1967 to 1970.

The amended complaint charges that Solitron issued an annual report on May 5, 1967 which contained false representations as to the company's sales, income, inventory, and accounts receivable, as well as material omissions as to the true financial condition of the company. Similar misrepresentations and omissions were evident, according to the plaintiffs, in Solitron's annual reports published on June 6, 1968, May 23, 1969 and May 27, 1970. In 1971 Solitron issued a financial statement containing a substantial write-down attributed to price changes in the industry, but, as alleged by plaintiffs, in fact prompted by an attempt to correct, at least in part, the fraudulent financial reports of prior years.

Plaintiffs stipulate that the annual report issued on June 1, 1971 correctly represented the company's fiscal 1970 sales volume and income. The fiscal 1970 figures were first published on May 18, 1971. Plaintiffs also concede that Solitron's annual report issued the following year, June 8, 1972, accurately stated Solitron's sales and operating income.

Plaintiffs contend however that the accuracy of the fiscal year 1970 and 1971 figures were undermined by a continuous pattern of fraudulent behavior during the period from May 5, 1967 to March 20, 1975. During this interval, it is said, Solitron's stockholders and the investing public were repeatedly lulled into a sense of security with regard to the company's wellbeing. Plaintiffs accuse Solitron of misleading

the public by failing to disclose (a) the true reason for the substantial write-off in fiscal 1970; (b) the contingent liabilities incurred because of the issuance of the prior false and misleading financial statements; and (c) liabilities arising out of an unrelated pending claim by the National Renegotiation Board regarding excess profits allegedly realized by Solitron on its government contracts for fiscal years 1967 through 1970.

Later, by the affidavit of Stephen D. Oestreich, Esq., sworn to July 15, 1976, plaintiffs requested that the initial class delineation sought be modified, and that three separate subclasses be designated, defined as follows:

> "(a) those persons who purchased Solitron stock during the period from May 5, 1967 to June 15, 1971 and who thereafter either sold said stock at a loss or still hold said stock (those who sold prior to June 15, 1971, while harmed by the misrepresentations and omissions when they purchased, got the benefit of the misrepresentations and omissions when they sold their stock);
>
> (b) those persons who bought Solitron stock during the period from June 15, 1971 to June 22, 1972 and who thereafter either sold said stock at a loss or still hold said stock; and
>
> (c) those persons who bought Solitron stock during the period from June 22, 1972 to March 20, 1975 and who thereafter either sold said stock at a loss or still hold said stock."

The dates used to delineate the three subclasses correspond to approximately two weeks after the publication of the Solitron annual reports in question. Two weeks is an approximation relied upon by the plaintiffs as the interval required by the public market place to absorb fully the contents of an annual report. This period seems unduly long. The Court believes that no more than two market days is necessary. The class dates should be established accordingly.

Each prerequisite of Rule 23(a), F.R.Civ.P. must be met, as well as those under one of the three subdivisions of Rule 23(b).

before a class action can be certified. In this action, the plaintiffs have selected 23(b)(3) from their 23(b) options. This Court has previously found and concluded by the aforementioned Memorandum and Order that the requisite numerosity of Rule 23(a)(1) is present, and that those affected are not so large in number as to prevent manageability.

The common question requirement of Rule 23(a)(2) and the predominance of such questions demanded by Rule 23(b)(3) is complicated by plaintiffs' accusation that defendants disseminated a series of fraudulent representations rather than a single omission or misrepresentation.

The complaint recounts an alleged scheme and common course of conduct to present a false and misleading picture of Solitron's true financial condition for the period beginning in or about July 7, 1967 through March 20, 1975, the latter representing the filing date of an action brought on behalf of the Securities and Exchange Commission against defendant Solitron. Plaintiffs contend that as a result of the fraudulent and misleading information disseminated by defendants to the investing public during the time stated, including financial statements certified by defendant Sternbach for part of that period, the market price of Solitron securities was artificially inflated in violation of § 10(b) of the Securities Exchange Act, and Rule 10b-5 promulgated thereunder. In essence, defendants are charged by their alleged misbehavior with having distorted the market, and those injured would constitute all those who purchased and were damaged as a result of such purchase, during the period in which the alleged conspiracy to obfuscate was in effect.

The Supreme Court has held in *Eisen* v. *Carlisle & Jacquelin*, 417 U.S. 150 (1974) that the court on a Rule 23 motion lacks power to "conduct a preliminary inquiry into the merits of a suit in order to determine whether it may be maintained as a class action." From the limited vantage point permitted under the *Eisen* doctrine, the series of statements and reports relied upon by plaintiffs in their pleadings provide the essential continuity of omissions and misrepresentations necessary to

bring the period from May 5, 1967 to March 20, 1975 within the scope of the common questions requirement.

The requirement of common questions of law or fact under Rule 23(a)(2) may be satisfied even if the allegedly false statements were made in several documents published over a period of time and even if the class members purchased at different times in reliance on different documents. It is, however, essential in such a case that plaintiff show that there is at least one common strand of misrepresentation running through all of the documents relied upon and polluting the market. Here fraudulent overstatement of Solitron's earnings and profits in each of the events and publications relied upon by the plaintiffs during the period of Solitron's supposed wrongdoing is sufficient. Plaintiffs have particularized their claim of a common fraudulent scheme with sufficient precision to enable the Court to regard the common questions requirement as satisfied.

In a class action brought under Rule 23(b)(3), not only must the plaintiffs convince the Court that common questions of law or fact exist, but they are also held to the burden of establishing that such questions predominate over the individual issues encountered in the action. Elements in this case do exist which are unique to the individual complainants. The Court, however, finds that these individual issues, including those of reliance, materiality, and damages, are secondary to the common questions outlined in the amended complaint. The Advisory Committee on Rule 23, commenting on the utility of class action treatment in securities fraud actions, stated:

> ". . . a fraud perpetrated on numerous persons by the use of similar misrepresentations may be an appealing situation for a class action, and it may remain so despite the need, if liability is found, for separate determination of the damages suffered by individuals within the class." Proposed Amendments to the Rule of Civil Procedure (1966) 39 F.R.D. 69, 103.

Where a unitary scheme to commit a fraud on the market is alleged with sufficient particularity, proof of individual re-

liance is frequently dispensed with. Defendants, relying on *Greenspan* v. *Brassler,* 78 F.R.D. 130 (S.D.N.Y. 1978), contend that the presumption of reliance can be rebutted in this case by proof that the integrity of the market and the alleged misrepresentations were not material to the plaintiffs' purchase or that plaintiffs relied exclusively on the advice of others, such as their brokers, in purchasing the Solitron stock. Defendants believe that these individual questions undermine the predominance of any issues of fraud which may be shared by the purported class.

In *Green* v. *Wolf Corp.,* 406 F.2d 291 (2d Cir. 1968), the Circuit Court in effect rejected defendants' argument by concluding that the existence of individual issues of reliance alone would not indelibly taint a potential class action:

> "Carried to its logical end, [the argument] would negate any attempted class action under Rule 10b-5, since as the District Courts have recognized, reliance is an issue lurking in every 10b-5 action." (Citation omitted). 406 F.2d at 301.

Proof of reliance in cases brought under a "fraud on the market" theory is beyond the scope of consideration permitted by *Eisen* in determining a Rule 23(b)(3) question. The shifting of the burden of proof on the issue of reliance and the inability of individual factual issues with regard to reliance to defeat class certification is summarized in *Sargent* v. *Genesco, Inc.,* 75 F.R.D. 79 (M.D. Florida 1977):

> "The plaintiff need not prove individual reliance upon the particular misrepresentations or omissions of defendants. Rather, the plaintiffs must prove that the facts misrepresented or omitted by defendants were material and affected the market value of the stock purchased. Once plaintiff has satisfied this burden, reliance is presumed and the burden shifts to the defendants to rebut that presumption. [Citation omitted]. Consequently, under a 'fraud on the market' theory questions of individual

> reliance are not sufficient reason to deny class action status."

The Court is empowered to conduct separate trials on the issue of reliance if such is shown to be required at a later stage in the litigation. The Second Circuit in *Korn* v. *Franchard Corp.*, 456 F.2d 1206 (2d Cir. 1972) lists several other alternatives which have been resorted to by the court in lieu of reliance. The mechanisms referred to in *Korn, supra* at 1212, include (footnotes omitted):

> "Split trials for individual proof on reliance (*Green* v. *Wolf Corp., supra,* 406 F.2d at 291), inferring from the materiality of the misstatement that a reasonable investor would have relied; stressing general reliance on a common course of conduct over a period of time; dispensing with or minimizing the need to prove individual reliance in cases of nondisclosure; using the test, in instances of omission, of whether the claimant would have been influenced to act differently, if the undisclosed fact had been made known, than he in fact did."

The Court in *Korn, supra* at 1212-13, noted the "strong and consistent trend" of the federal courts to adopt "various rules, mechanisms, or presumptions . . . for mitigating the problem of showing reliance." Forbidden as we are from scrutinizing the merits on this motion, we find the requisite predominance of common questions as required by Rule 23(b)(3).

The named plaintiffs in this action encounter some difficulty when attempting to qualify under Rule 23(a)(3) and 23(a)(4). Defendants oppose the class certification on the ground plaintiffs are not appropriate representatives for the purported class, that their claims and defenses are not typical of those held by other class members, that their interests are inimical to the interests of their class, and that the interests of each subclass is antagonistic to the interest of the other proposed subclass and that designated plaintiffs will not adequately represent their class.

Defendants accuse named plaintiffs of failing to satisfy the typicality requirement in that the latter are not valid members of the classes they seek to represent. In this regard, the Court finds that plaintiffs Greenberg and Weiner lack sufficient typicality to be designated as class action plaintiffs. Mr. Greenberg engaged in three buy and sell transactions with regard to Solitron securities, purchasing on September 16, 1968 and selling on October 21, 1968; purchasing on October 21, 1968 and selling on December 5, 1969; purchasing on August 12, 1970 and selling on November 21, 1970.

Examining these dates, it is evident that Greenberg does not fit within the plaintiff imposed confines for a Class I representative. Class I, as stated previously, consists of "those persons who purchased Solitron stock during the period from May 5, 1967 to June 15, 1971 and who thereafter either sold said stock at a loss or still held said stock." Greenberg bought and sold within the Class I period; plaintiffs make no claim of any disclosures prior to these sale dates which had an effect on the market. An inventory write-down, cited by plaintiffs as one of the series of frauds perpetrated by defendants, did not become public at the earliest until December 16, 1970, subsequent to Greenberg's holding period. Greenberg's claims are not typical of those of Class I; he cannot represent a class in which he is not a member. See *Bailey* v. *Patterson*, 369 U.S. 31 (1969); 3B Moore's Federal Practice, ¶ 23.04 at 23-354 (2d ed. 1976).

The same analysis applies to plaintiff Weiner who also bought and sold within the time frame established for Class III. Weiner also engaged in three transactions involving Solitron securities during the period of defendants' alleged wrongdoing. Weiner bought on October 9, 1973 and sold a portion of those shares on November 26, 1973, the remainder almost a year later, on November 4, 1974; he bought again on May 30, 1974 and sold on November 4, 1974. None of these sales followed any of the misrepresentations or nondisclosures asserted by plaintiffs to constitute the fraud. Unable to qualify as a member of Class III, plaintiff Weiner is not competent to serve as a representative Class III plaintiff.

Plaintiffs Family Restorations and Sirota appear to be appropriate Class I representatives. Family Restorations purchased on April 7, 1971 and sold on November 29, 1974; purchasing after May 5, 1967 and selling after June 15, 1971, the time bounds for Class I. Likewise, Sirota, purchasing on June 2, 1971 and selling on October 9, 1971, bought during the Class I period and sold afterwards. Berk, the proposed Class II representative, also qualifies for that position by virtue of the dates of his purchase, April 27, 1972 and sale, April 16, 1974. Umlas, buying on October 12, 1973 and selling on April 28, 1978, falls within Class III as proposed by plaintiffs, purchasing prior to the January 27, 1975 announcement of the unfavorable determination by the Renegotiation Board with respect to Solitron's government contracts and selling subsequent to both that disclosure and to the filing of the complaint in *SEC* v. *Solitron Devices, Inc.*, March 20, 1975, which exposed the alleged income puffing scheme complained of herein. Thus, except for plaintiffs Greenberg and Weiner, the named plaintiffs, Family Restorations, Sirota, Berk and Umlas all evidence the measure of typicality required by Rule 23(a)(3).

Defendants also oppose this motion for class certification on the grounds that the named plaintiffs are not adequate class representatives in that with respect to Umlas and Family Restoration, purchases of Solitron were made solely on the recommendation of brokers. Defendants also urge that named plaintiffs exhibit a lack of personal interest and involvement in the lawsuit, lack of appreciation of their financial obligations as class representatives, and maintain claims and defenses antagonistic to those of their class and interests inimical to those of the other subclasses.

That plaintiffs and their attorneys will prosecute the action vigorously appears sufficiently established on the record before me. While certain plaintiffs showed a lack of familiarity with some of the facts relating to the litigation, the Court believes that on the basis of the entire record they are adequate class representatives.

The argument that the claims of Umlas and Family restoration are vitiated by a showing, through deposition testimony,

that neither had independent information with regard to their purchase of Solitron but purchased solely on the recommendation of brokers, does not discredit both plaintiffs as adequate class representatives. There is sufficient evidence that both Umlas and Family Restorations were attentive investors, adequately involved in their claims and willing and capable of prosecuting those claims to the benefit of their respective classes.

The record also indicates that named plaintiffs are willing and able to undertake the financial obligations of designated representatives.

Antagonism among the plaintiffs based on differences between the claims of each subclass and conflicts of interest between the designated plaintiffs and their constituency presents a somewhat troublesome obstacle to class certification. The latter problem, the possible conflict of interest between named plaintiffs and their subclass, was considered in the discussion of the typicality of each plaintiff's claim; the conclusion that four of the six named plaintiffs evidenced sufficient typicality resolved that segment of the issue.

Defendants assert that a direct antagonism exists between Solitron shareholders who sold on or about a particular date and those who bought on or about that same date since it would be incumbent upon each class member to prove that the market price on the date of purchase was maximally inflated by the alleged representations and the market price on the date of sale was maximally depressed subsequent to the relevant disclosure. Likewise an argument can be proffered that such antagonism separates each subclass from the other subclasses in that it is in the interest of each subclass to show that those omissions or misrepresentations occurring within the time period characterizing their class had greater market impact than the fraudulent conduct occurring within the time period denoting any other class.

As observed in *Gill* v. *Monroe County Dept. of Social Services*, 79 F.R.D. 316 (W.D.N.Y. 1978), " . . . the mere existence of intraclass antagonisms does not automatically defeat a motion to proceed as a class." In a test for determin-

ing whether class differences jeopardize adequacy of representation under Rule 23(a)(4) gleaned from 89 Harv. L. Rev. 1317 (1976) "Developments in the Law—Class Actions," the Court in *Gill, supra* at 328, stated that " . . . some antagonism is inevitable because the Court is required to determine the culpability of a series of separate acts," but that " . . . judicial awareness of potential differences within the class affords sufficient protection to unrepresented class members."

We find that any natural antagonism between the proposed classes and within those classes between individual investors is subordinate to the common interests involved in the proof of a fraudulent scheme, with the existence and materiality of the alleged misrepresentations furnishing significant common issues, relevant to all purchasers who purchased during the existence of the scheme regardless of time of purchase. The Court is persuaded that the compelling common interest in establishing the existence of a fraud on the market insures that plaintiffs will fairly and adequately protect the interests of their class.

The Court has scrutinized all of the other arguments raised by the defendants and finds them ineffective in thwarting this class certification. The plaintiffs, with the exception of Greenberg and Weiner, have satisfied the four prerequisites of Rule 23(a) and the third subparagraph of Rule 23(b). The motion to proceed in this action as a class is granted within the limitations discussed above.

Settle an order on ten (10) days notice with appropriate provisions for notice to the class.

Dated: New York, New York
February 13, 1979

CHARLES L. BRIEANT
Charles L. Brieant
U.S.D.J.

Memorandum and Order of the District Court on Class Action

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

75 Civ. 1369-CLB

HOWARD SIROTA, FAMILY RESTORATIONS, a Partnership, SAMUEL GREENBERG, ARA STEPANYAN and ROBERT J. BERK, on behalf of themselves and all others similarly situated,

Plaintiffs,

—against—

SOLITRON DEVICES, INC., BENJAMIN FRIEDMAN, PAUL WINDELS, JR., RICHARD J. TRIVISON, R. W. HULL, BERNARD SIMMONS, P.C. SMITH, E. C. JAEGERMAN, JOSEPH GOLDMAN, J. S. TRAGER, J. P. BARRY, WALTER F. GREENWOOD, HERMAN MERINOFF, HENRY SINER and LOUIS STERNBACH & CO.,

Defendants.

And Four Other Actions Bearing 1975
Civil Actions Nos. 1383, 1463, 1667 and 3627.

MEMORANDUM AND ORDER

BRIEANT, *J.*

Pending before this Court for decision is a renewed motion by plaintiffs for a conditional order pursuant to Rule 23(c)(1), F.R.Civ.P., declaring that this consolidated case be maintained

as a class action under Rule 23(b)(3), F.R.Civ.P. for the benefit of a class of purchasers of the common stock of Solitron Devices, Inc. ("Solitron") hereinafter described. In addition, Louis Sternbach & Co. ("Sternbach"), a firm of Certified Public Accountants, which allegedly prepared some but not all, of the relevant financials of Solitron had moved by a purported "cross-motion" docketed May 11, 1976 for an order "denying, and/or staying the determination by this Court of the issue of whether or not the plaintiffs are entitled to class certification."

By a supplemental notice of "cross-motion" docketed July 23, 1976, and joined in by other defendants, Sternbach also sought summary judgment, but only as against the claims of certain named plaintiffs therein mentioned.

Familiarity is assumed with our prior Memoranda and Orders in these consolidated actions. The class action motion originally came on before me for hearing on May 12, 1976. At that time co-lead counsel urged the Court that the allegations showed that defendants, Solitron, its officers and directors, and the Sternbach accounting firm had carried out a "common and consistent course of conduct . . . to issue to the investing public materially false and misleading financial statements and reports which contained material misrepresentations and omissions of material facts which had the effect of inflating the market price of Solitron stock during the period from 1967 to 1970," which would present a common question of fact within *Green* v. *Wolf Corp.*, 406 F.2d 291, 300 (2d Cir. 1968) and *Fischer* v. *Kletz*, 41 F.R.D. 377, 381 (S.D.N.Y. 1966).

In 1971 Solitron issued a financial statement containing a write-down in excess of Nine Million Dollars, attributed to price changes in the industry, but, as alleged by plaintiffs, in fact caused by the fraudulent financial reports of prior years. In addition, plaintiffs claim that financial reports and releases, and interim reports between 1971 and 1975 failed to report contingent liabilities incurred because of the issuance of the prior false and misleading financial statements, and as a result of a pending claim for the renegotiation of government contracts.

At the hearing, plaintiffs' counsel asked that the sending of notice to the class be delayed in this litigation then pending more than a year. Plaintiffs' counsel conceded that while they claimed they had sufficient evidence to indicate that the action should be certified as a class action, they were "concerned with . . . the exact parameters of the class." (Tr. of May 12, 1976, p. 8). At that time plaintiffs were seeking to certify a class of purchasers of Solitron stock between July 10, 1967 through May 20, 1975, but admitted that they could not verify those dates in the absence of further discovery. The Court declined to certify a class pending resolution of this issue, and for those reasons continued the class motion until July 22, 1976.

This new date found the parties in a condition not materially improved. Defendants continued to oppose certification, and plaintiffs, by the Affidavit of Stephen D. Oestreich, Esq., sworn to July 15, 1976, requested that the class delineation originally sought in the motion be changed, so as to consist of three separate groups to be defined as follows:

> "(a) those persons who purchased Solitron stock during the period from May 5, 1967 to June 15, 1971 and who thereafter either sold said stock at a loss or still hold said stock (those who sold prior to June 15, 1971, while harmed by the misrepresentations and omissions when they purchased, got the benefit of the misrepresentations and omissions when they sold their stock);
>
> (b) those persons who bought Solitron stock during the period from June 15, 1971 to June 22, 1972 and who thereafter either sold said stock at a loss or still hold said stock; and
>
> (c) those persons who bought Solitron stock during the period from June 22, 1972 to March 20, 1975 and who thereafter either sold said stock at a loss or still hold said stock."

At the adjourned hearing it seemed apparent to the Court that the litigation probably should be certified as a class action. The requisite numerosity is present, but those affected are not

so large in number as to prevent manageability. Issues common to the class appear to predominate over individual issues. Bound as we are by *Eisen* v. *Carlisle & Jacquelin, Inc.*, 417 U.S. 150, 177 (1974), holding that we may not consider the merits of the suit in order to determine whether it may be maintained as a class action, we would certify the class now, and would direct immediate notice to the class members.

The difficulty is that it is by no means certain on the present record what the delineation or relevant dates of the class ought to be, nor is the Court convinced that there is any need for separate sub-classes as requested in the most recent representation of plaintiffs' counsel to the Court, previously quoted.

Accordingly, the Court will heed the request of counsel for Sternbach that "the motion for class certification should be . . . alternatively held in abeyance until such time as Defendants have had a [further] opportunity to conduct . . . pre-trial discovery." (Affidavit of Robert E. Meshel, Esq., filed September 17, 1976).

The motion is hereby referred to Hon. Sol Schreiber, United States Magistrate, to (a) schedule and supervise further pre-trial discovery bearing upon the delineation of the proposed class or classes; (b) hear and report with respect to the pending motion to declare a class; and (c) for all other pre-trial purposes. The motion for summary judgment will be considered by the Court after pre-trial discovery is completed, and upon hearing counsel further at that time, unless sooner directed.

So Ordered.

Dated: New York, New York
October 29, 1976

CHARLES L. BRIEANT
Charles L. Brieant
U. S. D. J.